



Intergovernmental Fiscal Transfer System

—A new model from a comparison between Sweden and China

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Abstract

Intergovernmental fiscal transfer is a kind of transition of fiscal revenues between the central government and a local government; it plays an important role in leveling social disparities, furthermore, it further promotes the long-term development of a country's economy. As a well-known social welfare state in the world, Sweden has a rich experience of social equalization. Our dissertation carries out a comparison between Sweden and China in respect of the intergovernmental fiscal transfer system, by means of case study. In addition, we conduct some research into related theories, such as the rationale of intergovernmental grants and the decentralization issue, to provide necessary support for our argument. In conducting our research we adopt an inductive approach. The case studies help us identify nine factors that impact the fiscal transfer system, along with the performances they respectively have in these two countries. We make a further investigation into their impacts and propose suggestions to improve China's transfer system. As the result of our research, we finally develop a new model which may help push China's intergovernmental fiscal transfer system towards the direction of equalization.

Key words: intergovernmental fiscal transfer, equalization, comparison

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Chapter 1 Introduction

The introduction sketches a general picture of the background of the dissertation. The research problems and the objectives are also discussed. Moreover, the limitations, definitions and research questions are defined. In addition, an outline is introduced.

1.1 Practical problem in Chinese Society

In recent years, Chinese economy has experienced unprecedented progress because China has embarked on a wide-ranging set of reforms. According to statistics released by the Chinese government, its GDP has grown by more than 7% annually over the past decades with the average GDP per capita reaching \$1087 in 2003. However, the reforms have brought some negative effects while improving the quality of life of the Chinese people significantly. One severe social problem accompanying the development of society is the emergence of a widening gulf between the wealthy and the poor, an obvious gap between the city and the rural areas, and a visible income disparity among different industries. The Giniceffcent, a famous international yardstick, can clearly illustrate this situation in China. The figure changed from 0.3 in 1980 to 0.458 in 2000, which means that the situation has reached an alarming level and may possibly trigger social unrest in the Chinese society. Consequently China is facing a dual pressure of developing the economy at a high speed and narrowing the income disparity at the same time.

As for the government of China, a priority issue is the serious financial imbalance between the eastern and western region in the country. Local governments in poor western regions holding a poor financial position cannot provide vital public services, while more advanced eastern cities are pursuing to fulfill their modernization. For instance, nearly 90 percent of the rural population in the western areas is without any

protection from risk-pooling schemes. A similar case can be found in the educational sector, as most of the western provinces in China still have difficulties in providing nine years of compulsory schooling. In order to solve this problem, the central government of China is experimenting with a new series of measures. An intergovernmental fiscal transfer system has acquired much attention as a useful and important tool and is currently established by the central government of China.

As public administration and business students in Sweden, we have learned a lot about the Swedish model. One outstanding feature of the model is that everyone can enjoy benefits from the welfare system equally. The Swedish government has displayed a sound performance to limit the distance between the rich and the poor. The intergovernmental fiscal transfer system in Sweden is both effective and scientific. Therefore, we think it is meaningful and practical for us to do some research in this area. We hope to find the most applicable theory in this area. In analyzing the most important factors in the Swedish transfer system, our main purpose is to create a suitable series of theoretic guidelines and institutions that can be effectively applied in China, will promote the establishment of a welfare state, and contribution to the formation of an equal society.

1.2 Defining Intergovernmental Fiscal Transfer

Intergovernmental fiscal transfer is a kind of transition of fiscal revenues between the central government and a local government, or between an upper-level government and a lower-level government. International experiences indicate that the intergovernmental fiscal transfer system impacts the equity and the efficiency of the whole fiscal system in many areas (Ma Jun, 1998, pp1).

In this dissertation, the concept of “intergovernmental fiscal transfer system” used in China’s case has the same signification as the concept of “equalization system” that

is used in Sweden's case.

1.3 Research Problem

As an instrument in dealing with the fiscal relations between the central government and sub-national governments in China, the intergovernmental fiscal transfer system plays an important role. Nevertheless, this system has so far remained slack and capricious. The responsibilities and fiscal revenue assignments between the central and sub-national governments are the premise (or basis) of a fiscal transfer system, and yet they still remain quite ambiguous at present in China. The forms of transfer are not conducive to equalization either. In addition, the current transfer system lacks transparency and publicity. From the central government to sub-national governments, efficient control and appraisal mechanisms within the system are also in need.

1.4 Research Objectives

In this dissertation, we plan to do careful research concerning the intergovernmental fiscal transfer system and its supporting theories, to develop a model which illustrates the establishment of a scientific transfer system with a direction of equalization.

1.5 Research Questions

This dissertation addresses the following research questions:

- What conclusions can we reach through analyzing the intergovernmental fiscal transfer system of both China and Sweden?
- Which factors should be considered when we establish a new model for

promoting the intergovernmental fiscal transfer system in China?

1.6 Limitation

We have tried to look for as many research results as possible in the field of financial grants. However, only a limited size of publications is available and this has largely restricted our investigations. In addition, we mainly focus on Chinese and Swedish cases and draw a comparison so that we can discover implications for the Chinese equalization system. However, the Chinese government emphasizes more on the economic growth than the equalization society achievement. Thus, for the practical use, our research will face the political obstacle. Further, due to the limit of time, we could not extend our research to include other developing countries that the social and economic conditions are similar to China, like India. Lastly, in the process of detecting this system we examine the examples in three cities in Sweden and one city in China. The instance of the Chinese city, however, may not fully represent the situation of local governments in the country, because of regional disparities.

1.7 Structure of the Dissertation

The dissertation is organized in the following chapters:

Chapter 2: This chapter presents the design of our research, our methodological strategy and scientific approach.

Chapter 3: In this chapter the theoretical framework is presented.

Chapter 4: This chapter presents a case study of China's intergovernmental fiscal transfer system, focusing on the case of Ningbo from which we draw a few conclusions.

Chapter 5: This chapter provides a case study of the Sweden's intergovernmental fiscal transfer system, followed by corresponding conclusions.

Chapter 6: This chapter presents the factors that should be considered when creating a new model concerning the intergovernmental fiscal transfer system in China.

Chapter 7: This chapter presents a summary of the dissertation, and proposes possibilities for future research.

Chapter 2 Methodology

In this chapter the methodology of our research is presented. The primary and secondary data collections are explained. Furthermore, research validity and reliability are put forward, followed by the research approach adopted in the dissertation.

2.1 Choice of Methodology

We conducted our research on the inter-government fiscal transfer system through a case study in China, since the system can promote social equalization, economic growth and political stability. Furthermore, we tried to review some already existing literature in this area and analyzed the Swedish experience of social equalization. Our aim was to be able to find some important factors that are vital to a successful fiscal transfer system. After that, a new model was formulated, which can be carried out in China in a short time.

For this purpose, we adopted an inductive approach where an established theory comes from case study and data collection. We did not want to pay much attention to the need to generalize, instead, our intention was to get a thorough understanding of the system. The dissertation planned to mainly describe the relationship between the fiscal transfer system and social equalization. The comparison between the Swedish fiscal transfer system and the Chinese transfer system had been done by means of case studies, which finally led to our new model. In addition, we identified the factors that are indispensable to an effective and successful transfer system through the case study on Swedish experience. So for these reasons and the fact that there is a wealth of cases, we founded the inductive approach the most suitable for our dissertation (Saunders, Lewis&Thornhill, 2003).

2.2 Research Philosophy

There are different ways of thinking of the development of knowledge, e.g. positivism, interpretivism, and realism. A positivistic research philosophy can be used when the researcher is an objective viewer who can draw general conclusions of the social reality (Saunders et al, 2003). This dissertation follows the lines of the positivistic philosophy as we feel the efficacy of it. We believe that we are able to reach general conclusions by studying social reality. However, we had simplified the theories that are important to our own model. We conducted an objective analysis of the cases in Sweden and China. In the meantime, we also borrowed some principles from the interpretivistic philosophy, as we made our interpretations through structural interviews.

2.3 Data Collection

To fulfill the purpose of this dissertation, data had to be collected and analyzed. We found a lot of secondary data that fit the purpose of the research. Many developed countries have done intensive research on the fiscal transfer system, which provide us with much useful information and data. We chose Sweden as our main target and some internationally well-known and representative nations as our main references, such as the USA, Japan, Germany and Australia. Our tutor recommended us several useful books, which saved a lot of time. Also, we spent much time collecting nearly two hundred related articles on the Internet and in the library of Kristianstad University.

On the other hand, we tried to find as much as primary data as possible through interviews and contact with the Swedish Ministry of Finance as well as with Ningbo's Financial Department, in order to best describe the present situations of the two systems and examine their changes and development. Fortunately, we obtained a lot of useful information and first-hand data from Mr. Persson, Mr. Tingvall and

Mr.Hansson. All of them are specialists with the Swedish Financial Department. In addition, thanks to our work experiences at the local financial departments in Ningbo Municipality, we have collected abundant and authentic data about the Ningbo's system, which was very helpful to our research.

Secondary and primary data could be classified into quantitative and qualitative categories, the two having distinct differences. Qualitative data base their meaning on what is expressed in words. As the collected data are not standardized, we classify them into categories and analysis is conducted using conceptualization (Saunders et al, 2003). For our plan, the data collected are largely qualitative, since they mainly come from case studies and surveys. We designed ten different questions and raised these questions to our interviewees.

2.4 Validity

Validity is defined as to what degree the findings really measure what they are aimed at measuring and if the findings are what they appear to be about (Lekvall & Wahlbin, 1993; Saunders et al., 2003). A good research should have a high validity. In our research, we tried to locate some related materials and secondary data from some authorities. For instance, our collected data mainly come from the Ministry of Finance in Sweden and the Financial Department of Ningbo in China. Meanwhile, we acquired a lot of information from written reports by the Swedish government. Based on these materials and data, our research can avoid incredibility as much as possible. In addition, we chose to focus on Stockholm and Ningbo because these two cities are typical and meaningful in terms of their fiscal transfer system in Sweden and China. Through analyzing the two cases, we can find some typical problems that need to be addressed and researched. Then we reached a conclusion with sufficient certainty as to which factors are indispensable to a successful fiscal transfer system, which is crucial for our newly created model.

2.5 Reliability

Reliability is related to how well the research method yields the same results on other occasions and if other researchers could reach similar results. In other words, reliability is high if the survey results in the same findings each time it is conducted (Saunders et al., 2003). In our research, we made arduous attempts to give our scheme a high reliability. As a start, we spent much time reviewing the most typical theories in connection with the fiscal transfer system to achieve an overall understanding of the theoretic framework. Meanwhile, we surveyed the whole process of the development of the Swedish transfer system from 1992 to 2005, especially the three reforms which occurred in different periods. Then we selected some representative persons as respondents in our interview. These persons include leaders and professional employees from the Financial Department and members of certain political parties. We followed a semi-structural interview and designed ten related questions, with our aim of making our research as objective as possible. Finally, we tried to analyze the case of Stockholm in Sweden, as the city is a main contributor to the Swedish transfer system, where a heated debate is currently developing about the system.

On the side of China, we chose Ningbo to be the centre of our case study. Since 1987, Ningbo has become a sub-provincial-level city further opening up to the outside world entitled to decisions in economic planning and management independent of the provincial government. It means that Ningbo is directly subordinated to the central government of China rather than Zhejiang Province in dealing with economic management issues, such as fiscal distribution.

There are six urban districts under Ningbo's jurisdiction, Haishu, Jiangdong, Jiangbei, Zhenhai, Beilun, and Yinzhou, three county-level cities of Yuyao, Cixi and Fenghua,

and two counties Xiangshan and Ninghai. This means Ningbo Municipality also has its subordinate regions. Thus, Ningbo is sandwiched between the central government and local administrations appear as a very meaningful example for a study about inter-government fiscal relations. We hope such an analysis can be both typical and credible to some extent.

Chapter 3 Theoretical Review

The theoretical framework is presented. First, we give the definition and classify different typology of inter-government grants. Second, we analyze local government economies by reviewing public expenditures growth theories, the economic roles of central and local governments and decentralization issues. Third, we discuss the rationale of inter-government transfer, including the finance of the local government, the purpose of different grants and the principles of grant designs.

3.1 Introduction

In 1928, the economist Pigou first revealed the conception of transfer. In his view, fiscal redistribution can help establish an equal welfare system (a study in public finance, 1928). Oates (1972) implies that redistribution has to be carried out by higher levels of the government.

In Article 9 of the *European Charter of Local Self-Government*, the necessity of grants to the governing system is presented.

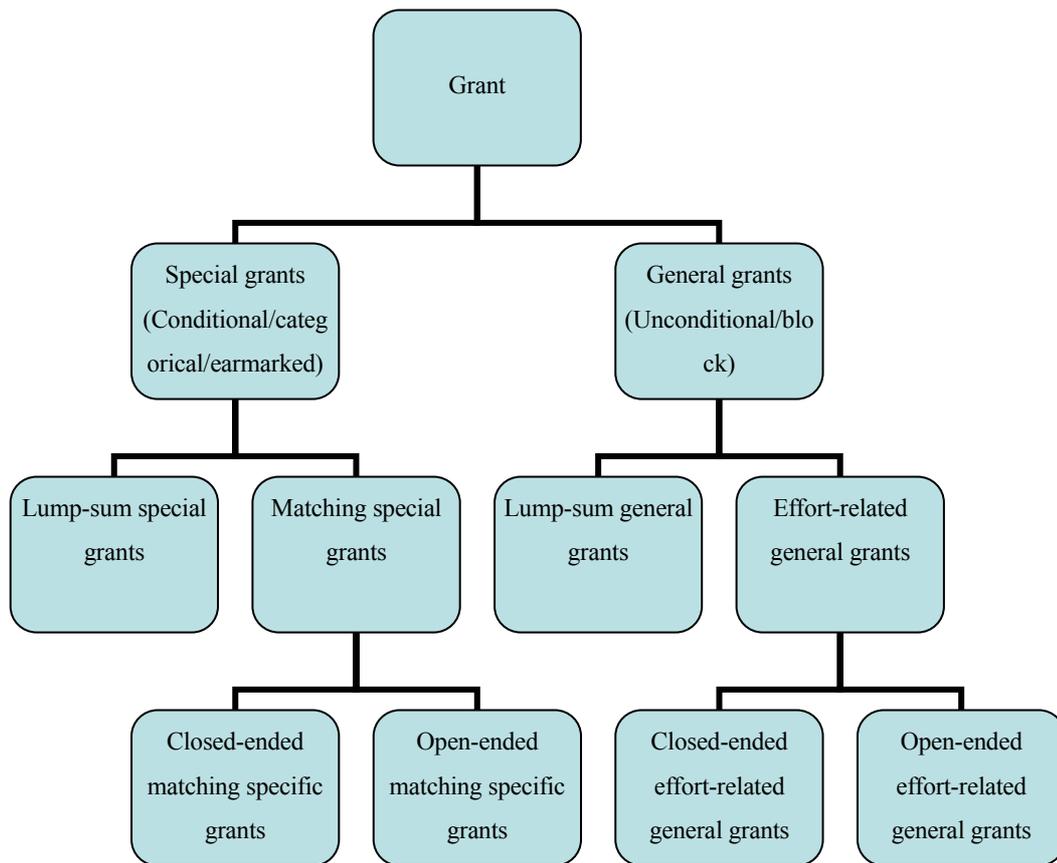
Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law. The protection of financially weaker local authorities call for the institution of financial equalization procedures or equivalent measures which are designed to correct the effects of unequal distribution of potential sources of finance and of the financial burden they must support. Such procedures or measures shall not diminish the discretion local authorities may exercise within their own sphere of responsibility. Grants shall not be embarked for the financing of specific projects As far as possible. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their

own jurisdiction.

According to the World Bank, inter-government fiscal transfer is a prime source of revenues of sub-national governments among most developing countries. The transfer mainly functions is maintaining efficiency and equality of local service provision and fiscal health of sub-national governments (Internet 1).

Stephen J. Bailey (1999) put grants into two main categories: *specific grants* and *general grants*, described as follows:

Graph3.1 A typology of inter-government grants



Source: Bailey, 1999, p.181

Specific grants are used for specific purposes defined by the granter. It can be

classified as conditional, categorical or earmarked grants. They function as an inducement for local services provision when spillover effects are substantial, or when a minimum standard of service is required by the central government. Specific grants can be lump-sum or matching (local government matches a certain percentage of the total expenditures).

General grants are paid to finance the local authorities to provide a broad range of services. They are also referred to as unconditional or block grants, the main function of which is to achieve horizontal and vertical equality, for example, grants used in education, leisure and so on. General grants maybe lump-sum or effort-related. Effort-related grants are related to the tax revenue that local authorities raise, in other words, the greater the revenue raised, the more grants the local authorities receive.

3.2 Issues in Local Government Economics

In a democratic society, local governments can be regarded as elected bodies whose jurisdiction is of local size, supported by powers to levy taxes by which they exert genuine role over local service provision (Cole and Boyne 1995). Although varying in geographic and democratic sizes, they have general power and obligation to undertake any activities related to local public interests.

3.2.1 Public Expenditures Growth Theories

Public expenditures rose rapidly in most countries during the 20th century. In the UK and the US, public expenditures occupied 42% and 35% of the GDP in 2002 respectively, while the figure at the start of the 20th century was about 10% (Miles, Myles, & Preston, 2003, p1).

Public expenditures encompass two categories: exhaustive expenditures and transfer payments. Exhaustive expenditures refer to government purchases that are used for

public goods, investment, consumption, etc. A transfer payment refers to the payment in which government transfers the money from taxpayers to recipients. Transfer payments largely go to welfare benefits, such as income support, unemployment benefits and pensions.

There are some macro models that explain the current increase of exhaustive public expenditures. 1) The *Development model*. Public expenditures are prerequisite of economic development. Initially, governments construct roads, railways, and water utilities. When the economy develops, governments invest in human capital like education, health, and a welfare system. Structural factors, for example industrial, demographical, and social factors determine the need for public expenditures. 2) The *Organic state model*. The state is assumed to be like a human organism. The organism will grow when the society's demands for services increase as per capita incomes grow. These services can be done by the private sector, but government intervention (subsidy, direct provision) is necessary to make economic allocation optimal. Due to the risk of market failure, the state is suggested to stabilize the price system for the market to function smoothly. 3) The *Political constraints model*. In a democratic society, taxpayers have great influences on what levels they would like to pay for public expenditures. People's willingness to pay taxes is connected with their expectations for what kind of services the government can provide. 4) The *Leviathan model*. This model assumes that government departments and agencies tend to promote the public sector, and that government employees have more political influence on public spending than the general public (Bailey, 2002, p49).

As for transfer expenditures, some factors are at play and lead to growth or decrease. The first is the *demographic structure*. The transfer payments are influenced by the elderly pension, child-care, health care, and personal social services. The second is the *household structure*, such as the increasing rate of single parent families. The

third is the *economic situation*. When unemployment increases, the government has to increase public spending on the jobseeker's allowance, income support, etc. The fourth is the *equity consideration*. The transfer payments and taxes, the government expenditures are based on the equality conception nation-wide. However, a complete equality has disincentive effects. For individuals, disincentive-to-work effects of high taxation plus high social security leads to lack of motivation to work. High taxation on private areas furthermore weakens the competition ability of private companies. In addition, as to local governments, equality payments reduce their desire to raise taxes. Usually, the median voters would favor a high redistribution income system (Bailey, 2002, p58.).

3.2.2 The Economic Roles of Central and Local Governments

In most countries, there are clear divisions between local and central governments. The local government usually provides services based on local interests, such as local roads, water supply, parks, and recreation facilities. As for the central government, it is mainly in charge of defense, diplomatic relations, motorways, etc. In some cases, where benefits extend beyond local boundaries, like education and health care, the responsibilities are often in the hands of both levels of governments. The rational division services of is determined by economic and political factors, and also related to the historical relationship between different levels of governments.

The four main economic roles of a government are the allocation, distributive, regulative and stabilization roles (Bailey 1995, ch.2). Among these roles, resource allocation is mainly the concern of local governments, while income distribution and stabilization are undertaken by the central government. Regulatory function is done primarily by the central government (Oates 1972; King 1984).

In a perfect market economy, *resources allocation* can reach the Pareto optimum¹ because all the product and factor prices can match their costs. Under such circumstances, it is impossible to relocate resources for the purpose of increasing output and impossible to alter the distribution of commodities to increase the welfare. But, in an imperfect market, which lacks perfect competition or where market prices do not reflect the costs and benefits of the products, it is hard to achieve the Pareto optimum. In this case, *government intervention* is justified if it corrects market failure (Bailey 1999, ch.1).

Many economic theories suggest that to provide public goods is the main resource allocation activity for the government. *Public goods* can be divided into two groups: national public goods and local public goods. Their assignment division is said to depend on how large an area benefits from the public goods. If the goods benefit all citizens, they should be provided by the central government, like defense. On the other hand, when the goods only benefit local voters, local governments take the responsibility. Services such as education, public order, etc, are dealt with on a local or lower level government in the UK, Germany and the US (Miles, Myles, &Preston, 2003, p26).

Another factor should be taken into account. That is the externality of public goods. For example, when citizens outside the local area mainly use a road within the territory, it is the up-level government that should take responsibility for building or managing the road (Jackson, 1993. p158).

Instead of simply dividing public goods into national and local ones, Oates (1972) and King (1984) attempted to find the optimum size of authority for the production of each of them. The optimum size should, on the one hand, have a greater ability to

¹ Pareto optimum refers to that allocation of resources is in the most efficient situation. The status cannot move without leading at least one person to be worse off.

exploit the economies of scale and diminish external effects, and on the other hand, be able to meet the variable preferences. Where economies of scales and external effects are very important, central provision may be the best, like defense. Where economies of scale and externalities are modest, the local government is suitable to take the responsibility to provide public products, such as parks, etc.

In practice, many local authorities provide education, elderly-care, and other social services. These products are called *merit goods*. Governments provide these products, because people tend to neglect their benefits or cannot afford them. As what happens to public goods, similar with merit goods, as to whether the central or local government provides the merit goods. When the redistribution responsibility is in the hand of the local government, the varying preferences from area to area can easily be met, but the *externality* can weaken the local government responsibility. For example, people may migrate from a poor area to a high welfare area and rich people may emigrate because of high taxes. The *prescription* for the problem could be that the central government controls the amount of redistribution and meanwhile permits local governments to consider the type of local services. In the U.S.A, local authorities rely on grants from state authorities to solve the education problem that population migration incurs, because migration makes it harder for local authorities to establish their own tax policy (Jackson, 1993. p162).

3.2.3 The Decentralization Issue

The World Bank defines Decentralization as “the transfer of authority and responsibility for public functions from the central government to subordinate or quasi-independent government organizations and/or the private sector—it is complex concept”(Internet 2).

According to Bailey (1999), decentralization has three forms: economic

decentralization, political decentralization and administrative decentralization. Within the EU, the decentralization principle has been broadly adopted. Most people agree that the government should exert powers at the lowest possible level. The European Charter of Local Self-Government declares the principle that the local government should be divided into entities as small as possible. Oates (1972) in his *decentralization theorem* notes that local governments are created under that preferences vary little within localities but vary largely between them.

Centralized public provision is subject to uniformity, failing to consider the local variations in preferences. National uniform services can lead to the loss of consumers' surplus, thus the local government is preferable to take the tasks as it increases efficiency of service provision (Bailey, 1999, cp.2).

There are two choices concerning the local authority discretion. The first is the centralized constraints model. In this model, the central government set out regulations for the local government and the local governments enjoy autonomy within the regulations. The second is *the bargaining model*, where the local governments are empowered by the constitution and the different levels of government should negotiate with each other in order to set up or implement national policies consistently and coherently. The historic evolution of the state also determines the local government's discretion (Bailey, 1999, cp.1).

Administrative decentralization refers to the transfer of responsibility of planning; budgeting and management of some public services from the central level to the local government or other public authorities. Financial responsibility is the core of administrative decentralization. In order to function their responsibilities effectively, the local government should make its revenue meet the financial demands of undertaking the responsibilities. In this sense, financial decentralization is

substantial and significant (*Internet 2*).

3.3 The Rationale of Inter-Government Transfer

3.3.1 Finance of Sub-Government

Sufficient revenue is indispensable for governments to fulfill their responsibilities. Broadly speaking, the revenues for sub-central authorities can be recruited from four sources: loans, charges, taxes and grants. David King analyzed the four resources as follows (Jackson, 1993, p168):

- *Loans*. The implication of loan finance and tax finance is identical if people were fully rational. The problem may occur when people migrate from one area to another area. The emigrants will benefit from the public spending without paying costs of loans. In addition, the loans are usually confined by the capital available.
- *Charges*. When providing the public services, both efficiency and equity factors need to be considered. Equity arguments generally favor charges. For it seems equitable for road costs to fall chiefly on the heaviest road users. On the other hand, efficiency requires zero-price tax-financed services. Due to public goods characteristics, excessive charges are not suitable.
- *Taxes versus grants*. Local demands for public services vary from area to area. In order to meet the preferences, local governments should have their own expenditures. From this point, it is important for sub-governments to determine their own policies of levying taxes. If they depend largely on the central government grants, they will lose control over local affairs. The effort-related grants can solve this dilemma. Under such a system, grants are transferred to

any area according to how much the area raises its taxes. But, the system may encourage excessive or super-optimal spending. In addition, the central government is answerable to its voters nation-wide for how revenue and grants are spent. So, it is entitled to set up regulations concerning local authority services, and consequently limits the strength of local governments to make decisions by their wishes. In western countries, a Robin Hood tax is adopted which transfers tax incomes from a rich area to a poor area.

3.3.2 The Purpose of Grants

It is common in developing countries or even in developed countries that sub-governments rely on grants from higher-tier governments in some degree.

David King (1984) pointed out that there are three reasons for grants. The first is to correct for externalities. Some sub-central services yield benefits to non-residents, for example a road that passes beyond the territory. In this case, grants are needed for sub-governments to meet a certain share of the total road cost. The second is the problem of finding suitable taxes for sub-central governments. Usually, the different levels of authorities levy different taxes to supplement their revenue. When the taxes levied are less than their need, the central government pays out revenue-sharing grants. The third is that inequalities between different areas should be diminished by means of equalization grants.

The purpose of *equalization grants* is to diminish the financial inequality between different areas. The fiscal horizontal inequality exists due to different taxable resources and local expenditure at per capita levels. The vertical inequality occurs because the jurisdiction for local governments levying taxes is not necessarily proper. The inequalities will have some consequences. First, people in different areas pay different taxes for the same standard of service. According to David King (1984), the

inequalities in tax rates for same public service standards could encourage migration from unfavorable areas to favorable areas. Such migration will use up resources in itself; in addition, it could result in people locating themselves in areas where their contributions are less than before if lower taxes can offset the lower wages (Jackson, 1993). Second, a local welfare state may collapse due to the fiscal stress. Third, high taxes imposed for enhancing the revenue, may force the population and business activities move out of the local area. Such a situation will further deteriorate the local economy. Therefore, the inter-government equalization grants should be provided to poor tax resources or high expenditure areas (Bailey, 1999, p191).

In the local tax revenues, the income and property taxes are the important resources in practice. But, the distribution of economic activities is uneven between central cities, towns and rural areas. It is the main cause of tax resources inequality.

As for the local expenditure needs per capita, inequality exists because of the differences in demographic, socioeconomic, geographic and other factors, such as population density, the proportion of elderly and children and the employment situation. These factors are so complicated that it is difficult to calculate the local expenditure needs accurately. Blair (1993) described some principles to assess the expenditure needs and to distribute the consequent inter-government grants: first, common needs indicators should be used in all local governments and over different periods; second, the needs indicators must be easy and objective; third, the indicators should link to the expenditures clearly; fourth, the indicators are not highly inter-dependent.

In Europe, some countries pursue full equalization by the grant system, like the UK and Denmark. Some countries seek partial equalization, such as France, Ireland, Italy and Switzerland. Adopting the partial equalization grants system has two reasons:

one aims at preserving local financial autonomy; the other is the central government lacks sufficient fiscal resource for full equalization (Bailey, 1999, p.195).

3.3.3 The Principle of Grants Design

As we analyzed above, inter-government transfer can help diminish fiscal gaps and inequity among the governments. Basically speaking, general grants are used to achieve these purposes, while the matching specific grants will be an incentive to solve the problem when externalities are existing. In this case, the share of benefit spillover to local benefit should be measured firstly. As public provision is the responsibility of the central government, the non-matching conditional grants will be provided to local governments to achieve the goal. Equity and efficiency are desired when setting up the pattern of a transfer system, from the view of public sector and local government economics, and decentralization issues.

The appropriate form of a transfer depends upon its objective in general. Regardless of the particular design, good intergovernmental transfer programs observe certain principles (Internet 1):

- Transfers should be designed in an objective and open way, ideally by some well-established formula. They maybe decided by the central government alone, or a grant commission, or some formal committees.
- Transfers are relatively stable to permit rational sub-national budgeting during a certain period, but also ensure that national stabilization objectives are not constrained by sub-national finances. Thus, stability and flexibility are both taken into account.
- The transfer formula should be transparent, and based on credible and objective

factors. In addition, it should be simple to understand and implement. In most developing countries, there are difficulties to design the formula, because of disputes about the regional and local population size.

- Transfers can assist local governments by both equalization purpose and special objective, such as education, local infrastructure. Clarity and effectiveness are preferable when different transfers are targeted for separate purposes.

Meanwhile, decentralization thematic term of the World Bank (2003) revealed several criteria for the transfer design besides the above principles, including: 1, the local governments have autonomy to decide their priority, and right to enjoy tax-base sharing, formula-base revenue sharing and block transfer; 2, the central and local governments should arrange the transfers equitably and efficiently; 3, local governments need have adequate finance to undertake the designated responsibilities; 4, the grant recipient should adhere to the purpose of the granter. “This is accomplished by proper monitoring, joint progress reviews, and providing technical assistance, or by designing a selective matching transfer program” (Internet 1).

According to Jorge Martinez-Vazquez (2002), some institutions are required to implement the transfers. From the beginning, credit data collection is necessary before deciding transfers. In addition, central government agencies or a special independent “Grants Commission” take the responsibility to design and monitor the transfers. The local governments should have the capacity to implement the transfer. Furthermore, adequate adjustment can be done when necessary. Finally, periodical evaluation is desirable in order that the transfers are done efficiently and equitable.

Chapter 4 The Intergovernmental Fiscal Transfer System in China

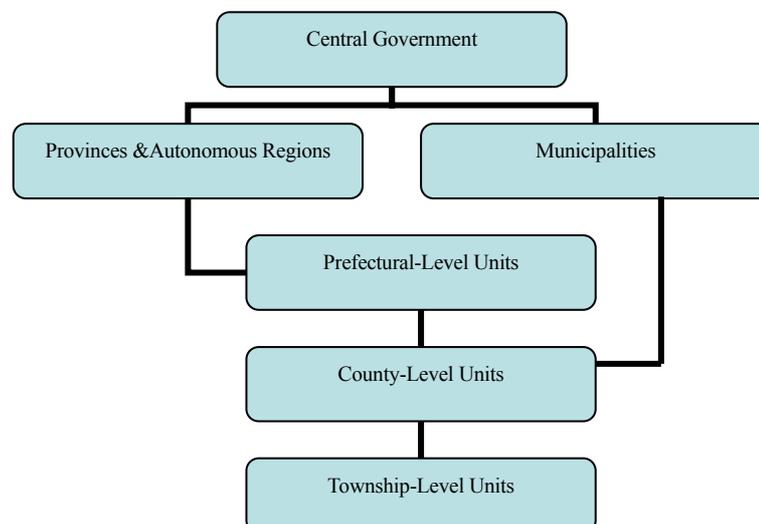
In this chapter, we will present a case study about the intergovernmental fiscal transfer system in China, focusing on the example of Ningbo. A background of China's current fiscal distribution system will be introduced in the beginning of the chapter, and then we turn to analyzing factors that result in disparities of fiscal revenues among the different counties in Ningbo, along with an investigation into the reasons behind these factors. At the end, we draw some conclusions about China's current fiscal transfer system.

4.1 China's current fiscal distribution system: TSS (Tax Sharing System)

4.1.1 A Brief Introduction to Fiscal Relation Levels

There are five levels of governments in China (Graph 4.1) and they are: the central government, the provincial (municipality and autonomous region) level government, the prefecture level government, the county level government and the township-level government. Below is a table indicating the five levels.

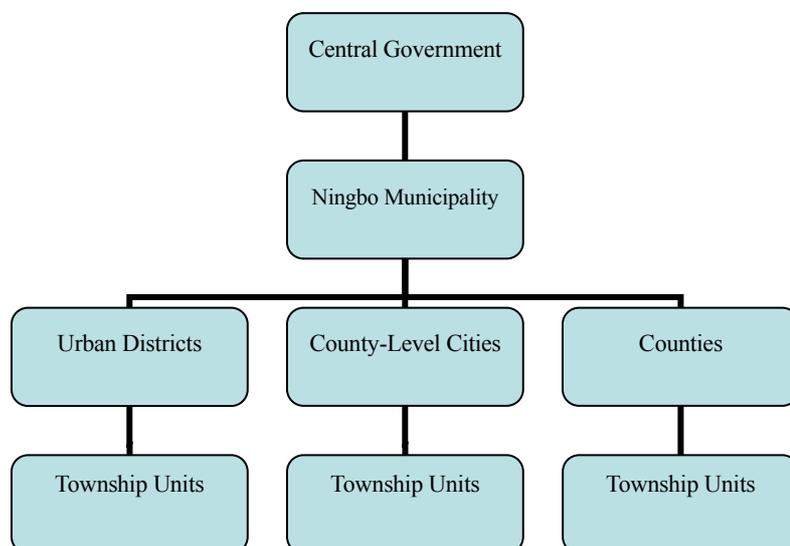
Graph 4.1 Levels of government in China



According to the Chinese Budget Law, each level should have an independent budget that is approved by the People's Congress at that level (article 2 and article 13, 1995). Consequently there are also five levels in China's fiscal system.

Before 1987, Ningbo was a prefecture-level city, subordinate to the Zhejiang Province. However, in 1987, to quicken its opening to the outside, the State Council lifted Ningbo to the status of a sub-provincial city, giving it the same rights as a province in economic planning and management. In other words, Ningbo is coordinate to Zhejiang Province in China's fiscal system but not in the political system, see Graph 4.2.

Graph4.2 Ningbo as a sub-provincial city



Due to its double identities (both provincial and prefectural), we can see the municipality of Ningbo contains four levels of government dealing with economic issues. In accordance with the Budget Law, there are also four correspondingly fiscal levels.

4.1.2 Political Motivations of China's Fiscal System Reform

From the end of the 1970s to 1994, China experienced three important reforms in its fiscal distribution system. They are: the assignment of revenue and expenditure based on the concept of "cooking in separate kitchens"² in 1980, the proportional sharing system in 1982³, and the fiscal contracting in 1988.⁴ The main political motivation behind these three reforms was the shift of the system from the fiscal centralization in the command-economy system to the fiscal decentralization during a transition period (1979-1993), accompanied by the incentives for local governments to increase their fiscal revenues. Particularly, with the introduction of fiscal contracting in 1988, the central government formally ended its responsibilities for financing local expenditure (the World Bank, 2001, p53). However, the negative sides of these reforms were also obvious. For example, the central government's share in the fiscal revenue was dramatically reduced, and as a result, the central government's ability to undertake macroeconomic control was weakened.

The fiscal reform in 1994 was a comprehensive package of measures designed to achieve three political goals: firstly, to stem fiscal decline and provide adequate revenues for governments, especially the central government; secondly, to eliminate the distortionary elements of the tax structure and enhance its transparency; finally, to renew central-local revenue sharing arrangements (the World Bank, 2001, p57).

The TSS (Tax Sharing System) is a combination of tax sharing on a derivation basis and own revenue assignment. Under the TSS, all taxes are assigned to the central government, local governments, or are shared (the World Bank, 2002, p5). The TSS marks a sharp break from the previous system in China. It has fundamentally

² "Cooking in separate kitchens" refers to the separation of both fiscal revenue and expenditure assignment between the central government and local governments (Zhang Zhihua, 2003, p2)

³ The proportional sharing system is a system in which fiscal revenues are classified into fixed central revenues , fixed local revenues and shared revenues between the central and local governments (Zhang Zhihua, 2003, p2)

⁴ The fiscal contracting is a system in which the central-local revenue sharing rate and the yearly growth rate of local revenues are based on the revenue performance of the province over recent years and negotiated by the central government and the local governments (Zhang Zhihua, 2003, p3)

changed how local governments are financed, and it has adjusted the central-local share and raised the share of local expenditures financed by central transfers (the World Bank, 2002, p5).

4.2 The Main Contents of the TSS

4.2.1 The Fiscal Expenditure Assignments on Central and Provincial Levels

According to *The Decision on Implementation of TSS's Fiscal Administration System*, the central finance is mainly responsible for the running costs of national securities, foreign issues and central level organs, expenditures for adjustment of national economic structure, harmonizing regional development, and executing the macroeconomic control. Local finance is mainly responsible for local organs and local economic development. Table 4.1 shows the specific expenditure items in central and local finance.

Table 4.1 Expenditure items of central and local finance

<i>Central government's expenditure</i>	Defense; armed polices; diplomatic issues; central level administration; central controled infrastructure; technical upgrading and R&D of national enterprises; geographic survey; agriculture; governmental debt services; central courts, public security, procuratorial and judicial organs; national culture, education, health, science.
<i>Local government's expenditure</i>	Local governmental administration; local courts, public securty, procuratorial and judicial organs; parts of armed polices; militia; local infrastructure; local enterprises' technical upgrading and R&D; agriculture; urban maintenance and construction; local culture, education, health; price subsidies and other expenditures.

(Source: *The Decision on Implementation of TSS's Fiscal Administration System*, the State Council, 1994)

4.2.2 The Coverage of Fiscal Revenue at Central and Local Levels

According to the policies devised in the reform, taxes related to the national sovereignty and macroeconomic control are identified as central taxes, taxes directly

connected with economic development are identified as shared taxes, and taxes collected by local governments are identified as local taxes (the State Council, 1994, p4). Table 4.2 indicates the sources of fiscal revenue between central and local levels.

Table 4.2 Sources of fiscal revenue at central and local levels

<i>Central taxes</i>	Custom duties; consumption tax; VAT revenues collected by customs; income taxes from national enterprises; remitted profits, income taxes, and business taxes of banks and non-bank financial intermediaries; urban construction and maintenance taxes of railroads, bank headquarters and insurance companies; resources taxes on offshore oil extraction
<i>Local taxes</i>	Business taxes (excluding those named above as central fixed incomes); income taxes and profit remittances from local enterprises; urban land use taxes, personal income taxes; fixed asset investment orientation tax; urban construction and maintenance tax; real estate taxes; vehicle utilization tax; stamp tax; animal slaughter tax; agricultural tax; title tax; capital gains tax on land; state land sales revenues; resource taxes derived from land-based resources
<i>Shared taxes</i>	VAT (central 75%, local 25%); securities trading tax (central 88%, local 12%)

(Source: The Decision on Implementation of TSS's Fiscal Administration System, the State Council, 1994)

4.2.3 A Brief Introduction to China's Fiscal Transfer System

The fiscal transfer system is an essential element of the current TSS, and it consists of four kinds of grants:

Tax Rebate: A tax rebate is done in a transition manner, aiming to maintain local vested interests. The value-added-tax (VAT) rebate, which came into being in the reform of the TSS in 1994, takes the actual VAT revenues of local governments in 1993 as its base figure.

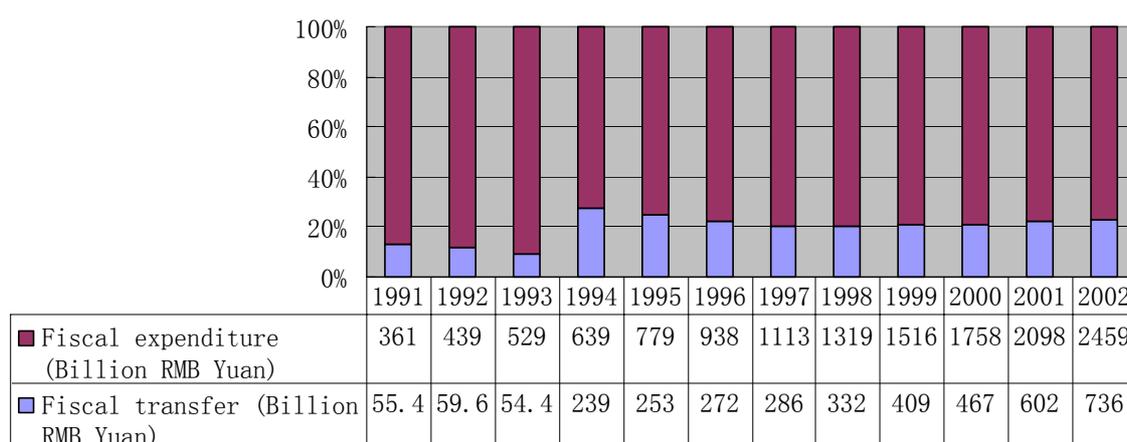
Earmarked Grant: An earmarked grant is special grant aiming to ensure that upper-level government's policies are implemented efficiently on lower-levels.

Equalization Grant: An equalization grant is a general grant with the function of equalization, calculated by a set of formulas designed to distribute the fiscal funds equally among the various sub-national governments.

Final Account Settlement Grant: A final account settlement grant is a grant originated from the former command economy in China, and it still deals with the transactions between upper-level government and lower-level government as a supplement to other fiscal transfer forms (Meng Lizhen, 1996, p228).

From 1991 to 2002, the amount of fiscal transfers experienced a distinct increase, with an annual increase rate of more than 40%. Graph 4.3 shows the stable share of fiscal transfer in annual fiscal expenditure of China, in which there ever been a dramatic jump from 1993 to 1994, but since then it maintains on the similar level of 20%. Since the TSS was first implemented in China in 1994, it is undoubtedly that the TSS reform had a far-reaching impact on the current fiscal transfer system.

Graph 4.3 Fiscal expenditure and fiscal transfer in China (1991-2002)



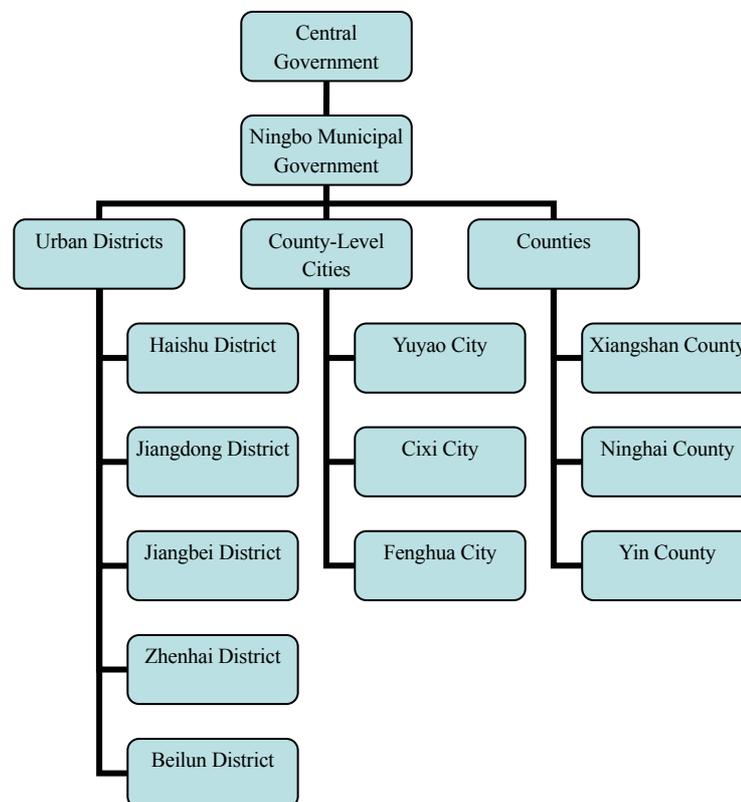
(Source: *The State Budget and Settlement Collection (1991-2000)*, Financial Ministry, the Budget Report of 2002/2003)

4.3 Case Study: Ningbo

4.3.1 Scope and Coverage of This Case Study

This case study focuses on the status of the municipality-to-county fiscal transfer system. It which means we mainly study the system at the second level (Ningbo) and the third level (Urban districts, county-level cities and counties) of the fiscal levels in Ningbo, in accordance with Graph 4.4.

Graph 4.4 Fiscal levels in of Ningbo



These two intermediate levels are the core of Ningbo's fiscal system, whose fiscal revenues account for 70% of the total fiscal revenue (Ningbo Municipal Government, 1997, p3). In addition, there are 165 towns subordinated to the county level, but it is impossible for us to do research on all these towns in such limited time.

We have chosen to concentrate on three county-level cities and the three counties in the third level units: Yuyao City, Cixi City, Yin County, Fenghua City, Xiangshan County and Ninghai County.

4.3.2 The Composition of Local Fiscal Revenue in Ningbo

Similar to the revenue assignments on central and provincial levels, fiscal revenue in Ningbo consists of local tax revenue and fiscal transfer revenue. However, there are no equalization grants on the county level. In the table below, we can see that the local tax revenue and tax rebate play a dominant role in county-level fiscal revenue.

Table 4.3 Components of fiscal revenue of Ningbo

	1994	1996	1998	2000	2002
<i>Local tax revenue</i>	46%	54%	55%	59%	62%
<i>Tax rebate</i>	49%	40%	35%	30%	31%
<i>Earmarked grant</i>	4%	4%	7%	9%	5%
<i>Final account settlement grant</i>	1%	2%	4%	2%	2%
<i>Total</i>	100%	100%	100%	100%	100%

(Source: *Ningbo Municipal Fiscal Revenue and Expenditure (1994-2002)*)

4.3.3 Analysis of Disparities of Fiscal Revenue Per Capita Since 1994

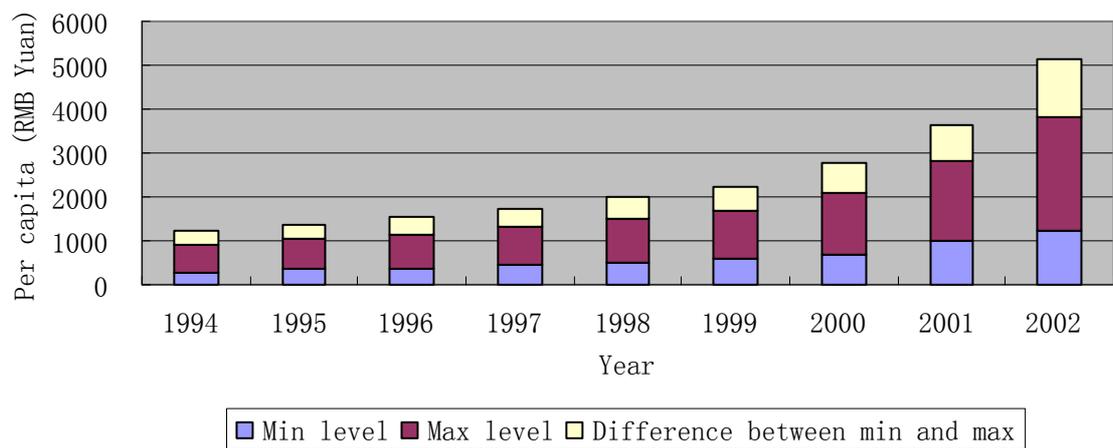
Table 4.4 and Graph 4.5 below both display fiscal revenues per capita within these six counties from 1994 to 2002. The differences between the highest and the lowest per capita are 318 Yuan, 330 Yuan, 390 Yuan, 416 Yuan, 498 Yuan, 533 Yuan, 813 Yuan and 1334 Yuan respectively, and the difference of fiscal revenue per capita between these six counties are steadily increasing.

Table 4.4 Fiscal revenue per capita (1994-2002) Unit: RMB Yuan

	1994	1995	1996	1997	1998	1999	2000	2001	2002
<i>Cixi</i>	400	459	488	517	586	708	900	1353	1835
<i>Yuyao</i>	464	537	576	608	682	760	900	1347	1644
<i>Fenghua</i>	379	436	482	523	576	671	842	1155	1318
<i>Xiangshan</i>	301	387	412	543	613	650	802	1039	1289
<i>Ninghai</i>	288	352	380	446	498	579	694	1010	1245
<i>Yin County</i>	606	683	770	862	996	1112	1384	1823	2579

(Source: Ningbo Municipal Fiscal Revenue and Expenditure (1994-2002))

Graph 4.5 Fiscal revenue per capita (1994-2002)



Two important questions arise at once: why is there a disparity? Does the fiscal transfer system work well in equalizing the fiscal revenue? Just as explained in earlier chapters, fiscal revenue on county-level consists of four different forms. Hence, we will try to analyze the disparity factor by factor: local tax revenue, tax rebate, earmarked grant and final account settlement grant.

4.3.4 Primary Factors Leading to Disparities on County-Level

According to Table 4.5 and Graph 4.6, there are two extreme counties Yin County and Ninghai County. The former has the highest tax revenue in these nine years,

while the latter has the lowest. In drawing a comparison of these two counties' economic performances, we select three indexes such as GDP, output of large enterprises and the amount of import and export. Normally, local tax revenue reflects the degree of local economic development, which is also true in this case. In 2000, Yin County reached a GDP of 15.39 billion Yuan, while that of Ninghai County was 6.37 billion Yuan; output of large enterprises in Yin County was 24.69 billion Yuan, and in Ninghai County's 6.65 billion Yuan; as to the amount of export and import, Yin County figure was 731 million US dollars, and Ninghai County merely 183 million US dollars (Ningbo Yearbook 2001, p510-512). Generally speaking, Yin County performs better than Ninghai County in local economic development and it has more powerful tax resources than Ninghai County. Other data of 1999 further proves this point. The more developed economy a county has the more local tax revenue it can raise.

Table 4.5 Local tax revenue per capita (1994-2002)

Unit: RMB Yuan

	1994	1995	1996	1997	1998	1999	2000	2001	2002
<i>Cixi</i>	198	233	269	288	339	433	579	988	1231
<i>Yuyao</i>	220	271	316	338	393	453	541	979	1026
<i>Fenghua</i>	170	208	248	247	274	321	419	705	741
<i>Xiangshan</i>	128	192	225	246	293	350	441	669	722
<i>Ninghai</i>	128	158	192	195	232	301	375	672	714
<i>Yin County</i>	273	347	423	482	588	680	866	1307	1637

(Source: *Ningbo Municipal Fiscal Revenue and Expenditure (1994-2002)*)

Graph 4.6 Local tax revenue per capita (1994-2002)

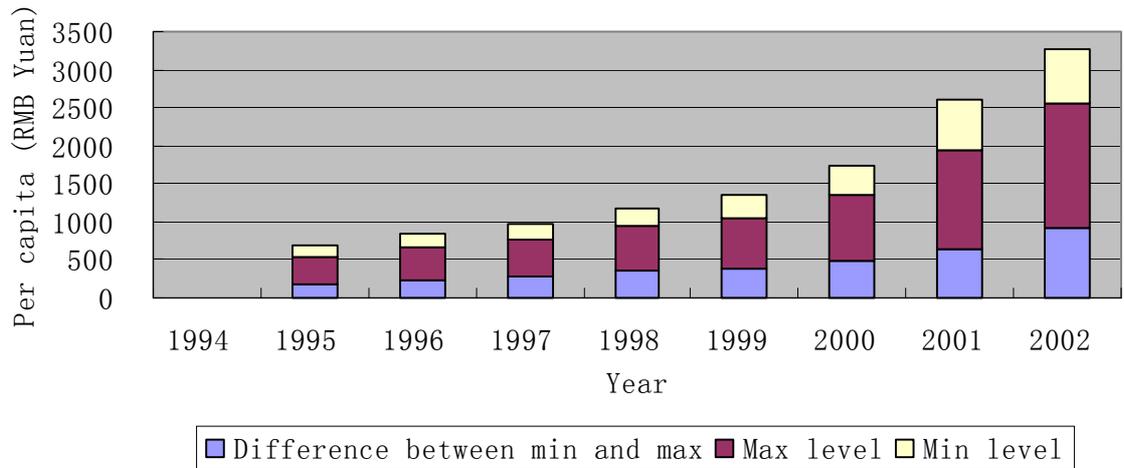


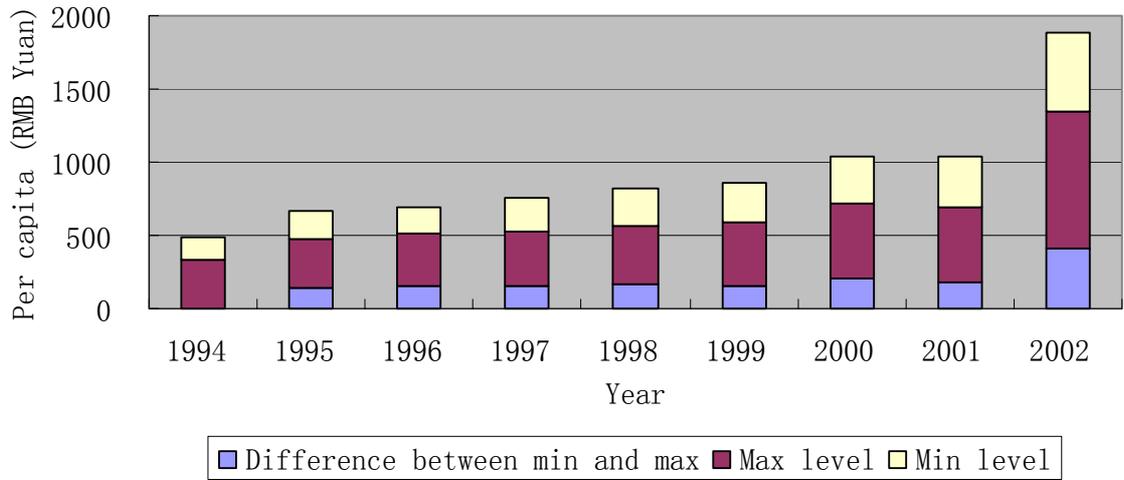
Table 4.6 and Graph 4.7 indicate the fiscal transfer per capita of six counties from 1994 to 2002. To our surprise, the extent in disparities of transfer revenue per capita is similar to that displayed in the former two tables--the richer counties receive a higher level of grants from the municipality, while the poorer counties obtain a lower level. For example, Yin County, the richest county in Ningbo, received the largest amount of grant in these nine years, yet by contrast, the relatively undeveloped counties such as Xiangshan County and Ninghai County, got the lowest level grants most of these nine years. It is obvious that the transfer system does not work well in fiscal equalization.

Table 4.6 Fiscal transfer per capital (1994-2002) Unit: RMB Yuan

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Cixi	202	226	218	229	247	275	321	364	604
Yuyao	244	267	261	270	289	307	359	368	618
Fenghua	209	228	234	276	303	350	423	450	577
Xiangshan	173	195	187	298	321	300	361	370	567
Ninghai	159	195	188	251	266	278	319	338	531
Yin County	333	336	347	380	408	432	518	517	942

(Source: Ningbo Municipal Fiscal Revenue and Expenditure (1994-2002))

Graph 4.7 Fiscal transfer per capita (1994-2002)



4.3.5 Two Primary Conclusions About The Disparities in Fiscal Revenue Per Capita

First, due to different levels of economic development, local tax capacities vary both within the different regions and different periods. If we look at the share of tax revenue in local fiscal revenue (Table 4.3), we will find that degrees of local economic development justify the disparities in fiscal revenue between the six counties.

Second, the fiscal transfer system fails to reduce the differences of fiscal revenue between the different regions. Hence its equalization function does not work efficiently. In contrast, the amount of the grant a county received from the municipality is highly correlative to the degree of its local economy development in the positive direction.

4.3.6 The Further Research about the Disparities in Fiscal Transfer System

As mentioned above, Ningbo's municipality-to-county fiscal transfer system is realized in three different forms: tax rebate, earmarked grants and final account

settlement grants. In order to analyze the effects of equalization of these three kinds of grants, we have selected Yin County and Ninghai County as examples.

Table 4.7 The roles of three kinds of fiscal transfer in equalization in two selected counties (1994–2002)
Unit: RMB Yuan

	1994	1995	1996	1997	1998	1999	2000	2001	2002
<i>Earmarked grants per capita</i>									
Ninghai County	15	21	26	59	76	81	103	68	91
Yin County	19	26	11	26	31	36	62	54	84
<i>Final account settlement grants per capita</i>									
Ninghai County	4	28	12	37	27	26	24	66	38
Yin County	5	0	10	15	20	16	18	11	18
<i>Fiscal transfer per capita 1</i>									
Ninghai County	19	48	37	96	104	107	127	134	128
Yin County	25	26	21	41	50	52	79	65	102
<i>Tax rebate per capita</i>									
Ninghai County	141	146	150	155	162	171	192	204	403
Yin County	308	309	326	339	357	380	439	452	839
<i>Fiscal transfer per capita 2</i>									
Ninghai County	159	195	188	251	266	278	319	338	531
Yin County	333	336	347	380	408	432	518	517	942

Note: Fiscal transfer per capita 1=earmarked grant per capita + final account settlement grant per capita

Fiscal transfer per capita 2=fiscal transfer per capita 1 + tax rebate per capita

From Table 4.7, we can see that from 1995 to 2002, Ninghai County received a higher level of both earmarked grants and final account settlement grants than Yin County. In association with the economic development level of these two counties, we can see that both earmarked grants and final account settlement grants have an equalization function. However, if the tax rebate is added, then the situation is immediately reversed, which means that Yin County's fiscal transfer is higher than that of Ninghai County, if the tax rebate is considered.

It is clear that both earmarked grants and final account settlement grants have an equalization function, but tax rebate is not only unable to reduce the gap of fiscal revenue between different counties, but also appears to have exacerbated the growth

of regional disparities. Tax rebates are in the absolute majority of the three kinds of fiscal transfers (See Table 4.7), and this is the direct factor leading to the disparities in county-level fiscal revenue.

4.3.7 The "Hold Harmless" Principle: a Knife with Double Blades

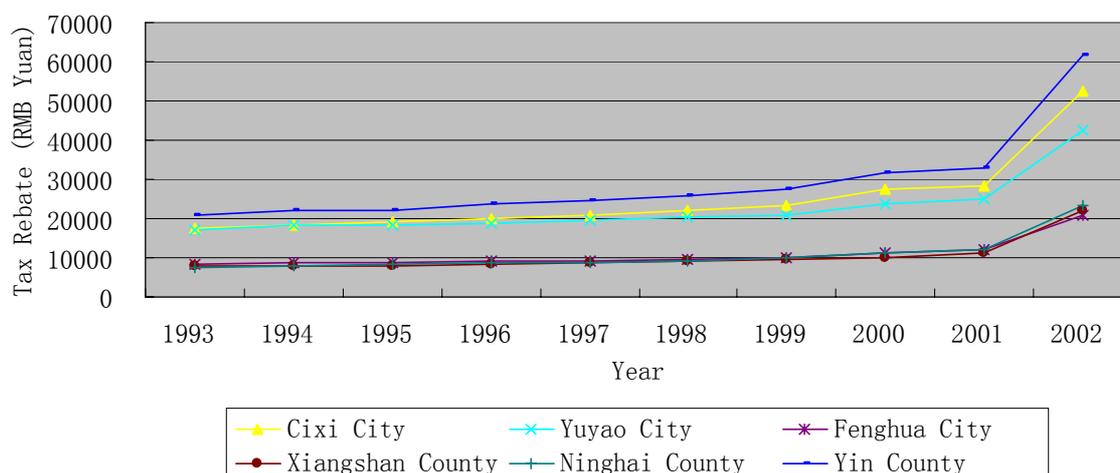
Now, let's come back to the TSS itself. When China's central government decided to establish the TSS instead of the fiscal contract in 1993, it encountered resistance, mainly from the local governments, who were afraid that the central government would substantially deprive them of fiscal revenue. In order to follow through the TSS in 1994, the central government adopted the "Hold Harmless" principle (the World Bank, 2001, p13) to relax the tension between central and local government. "Hold Harmless" means that the central government guarantees local vested interest formed before the 1994's fiscal reform. According to the 1994's TSS, the central government will collect 75% of the VAT, while 25% belongs to the local governments. As a compensation of the local tax revenue loss, the central government committed to give each province tax rebates. This principle was also adopted in dealing with the distribution relation on sub-national levels, such as the relation between municipal level and county level in Ningbo.

How was the base year tax rebate determined on? According to the *Decision on Implementation of TSS's Fiscal Administration System*, the base year tax rebate = $PBR - (LT + 0.25 \times VAT)$, where PBR is the Province's Base retained Revenue in the base year 1993. The new tax base consists of the newly designated Local Taxes (LT) plus 25% of the VAT.

In addition, tax rebates in the following years are calculated by using the following formula: tax rebate for province i in the year t = tax rebate _{i , $t-1$} \times $\{1 + 0.3 \times [0.75 \times VAT_i \text{ increase} + CT_i \text{ increase}]\}$ (CT refers to Consumption Tax) (the World Bank,

2001, p13). This means that the tax rebate will be increased if the VAT or CT increases in the following years.

Graph 4.8 Variations of tax rebate from 1994-2002



Note: 1993 is the base year, it is included in graph.

(Source: *Ningbo Municipal Fiscal Revenue and Expenditure (1994-2002)*)

Graph 4.8 shows the increase tendency of tax rebate of the six counties since 1993. In fact, the tax base itself has the characteristic of disparity in fiscal revenue when it emerged, because it belongs to “vested interest” under the “Hold Harmless” principle, and has nothing to do with the purpose of equalization. In 2002 and 2004, two other important fiscal reforms—income tax reform and export tax rebate mechanism reform—were introduced by the central government. Similarly, the "Hold Harmless" principle was adopted again. Graph 4.8 shows a significant leap of the share of tax rebate in 2002, indicating the further enlargement of disparity of regional fiscal transfer revenue.

In sum, tax rebates are products of the “Hold Harmless" principle. Everything has two sides. Tax rebates promoted the TSS reform in the middle of 1990s, at the expense of increased regional disparities of fiscal revenue.

4.3.8 Negative Aspect of Earmarked Grant

4.3.8.1 *Less Regulated Expenditure of Earmarked grant*

As mentioned above, the earmarked grant is designed to ensure the central (or upper level) government's policies to be implemented efficiently at the sub-national level. Hence, we conduct a study in an attempt to identify the effects of earmarked grant expenditure.

The percentages of selected expenditure items of earmarked grants on county-level in Ningbo shows the expenditure shares all seem ill-regulated. For example, the capital construction item accounted for 13.8% of total earmarked grants in 1996, but for 7.9%, 41.6% and 18.4% in 1998, 2000 and 2002 respectively; technological upgrading and R&D was 8.6% both in 1996 and 1998, but amounted to more than 18% in 2000 and 2002.

As stated in the former chapter, in 1994, the TSS provided a broad but brief guideline on how to assign expenditure responsibilities between the central government and provincial governments. Accordingly, the situation was the same in Ningbo, as described in a paragraph of a document from the Ningbo Municipal Government on the main expenditure responsibilities between the municipal government and the county level governments:

The expenditure assignment should be determined on the basis of assigned responsibilities. The municipal government is mainly responsible for the running costs of municipal organs, of promoting and controlling local economic development, and of balancing the intra-municipal economic development; county (city, and urban district) level governments are responsible for the running costs of their own organs, along with the costs of developing the local economy and

society (Ningbo Municipal Government, 1994, p4).

With no specific government guidelines on the distribution of responsibilities between the municipal and county levels, each county can potentially have a different assignment of expenditure responsibilities. Furthermore, one county may have different assignment of expenditure responsibilities in different years, as demonstrated above. In other words, earmarked grants lack stability.

4.3.8.2 *The lack of Legislation and Supervision in Managing Earmarked Grants*

The construction of legislation lags behind the evolution of earmarked grants. In Ningbo, all earmarked grants are appropriated following the release of written documents of the municipality rather than as a result of legislation. Therefore, such actions lack the effect of law and there is a very large space for finance department and other departments to arrange the schedule of appropriation. Table 4.10 sums up the appropriation schedule of the county-level earmarked grants in 2000, with the schedule referring to the share of each season's grants appropriated. We can see that a big proportion of the grants delivered to counties arrived in the last two quarters of 2000, which amounted to 72% of the total that year's grants. This means that county level governments would not receive most of their grants until the latter half year, and consequently they could not plan their budget accurately in advance.

Table 4.10 Schedule of appropriating earmarked grants in 2000

<i>Season</i>	I	II	III	IV	Total
<i>Schedule</i>	4%	24%	30%	42%	100%

(Source: *Ningbo Municipal Fiscal Revenue and Expenditure (1994-2002)*)

Due to the shortage of a legislative backup, decisions and operation of appropriations sometimes lack democracy and would proceed with less transparency. Besides the

financial departments, other departments may also decide the appropriation of fiscal grants, and to some degree, the amount of fiscal grants that a local government will acquire depends on its ability to bargain with the upper level government. Furthermore, calculation of grants is not scientific. In Ningbo, no equalization grants follow any well-designed formulas to calculate the proper amount of grants to deliver, and some earmarked grants are actually settled at a rigid size to a county government. Such flaws lead to results which may deviate from the original purposes of an earmarked grant.

The feedback system of the fiscal grants is also not efficient enough, either. Rules of financial management require all units using earmarked grants submit a report on the efficiency of the grants to the financial departments on a regular basis. However, such work is always omitted from the agenda of the grants users. Financial departments cannot acquire information concerning fiscal grants, and it is also difficult for them to enhance the supervision on the usage of fiscal grants. Some earmarked grants are misused by lower-level governments.

4.4 Some Conclusions from Ningbo's Case Study

As one example of Chinese intergovernmental financial transfer system, the Ningbo case study gives the following perspectives about the current fiscal transfer system of China:

The fiscal transfer system plays an important role in dealing with intergovernmental fiscal relations, it launches the TSS as an integral system, together with the assignment of both revenue and expenditure between the central and local government. The fiscal grants have been one of the irreplaceable elements of the local government's fiscal revenue. Especially to those local governments with weaker fiscal capacities, where fiscal grants can reduce the differences between their

fiscal revenue and expenditure, ensuring the local finance to operate with stability. Although taking up a marginal share in the whole fiscal transfer system, earmarked grants and final account settlement grants are helpful in equalizing the disparities of both fiscal revenue and expenditure among different regions in China.

The “Hold Harmless” principle has become the core of China’s recent fiscal reforms in dealing with the fiscal relations between the central and local governments. It has demonstrated its advantages in promoting fiscal reforms in China, where tax rebate is made the primary tool of compensating the local government’s loss of fiscal revenue, but it also enlarges the gap in fiscal revenues of different regions, which leads to a result that deviates from the original function of fiscal transfers. We think it conflicts with the original intention of the fiscal transfer system. The lower level of both equalization and stability of society will finally affect the development growth of China’s economy in the long term.

With no specific government guidelines on the distribution of responsibilities between different levels of government, a government at each level can reveal a different picture of expenditure responsibilities; furthermore, one local government may shift its budget to different expenditure areas in different years. Therefore, it is very difficult for an upper level government to establish a stable earmarked grant mechanism.

The lack of legislation and supervision lead to some weaknesses in the decision and supervision of fiscal grants. Without a legislative procedure, there is a very large freedom for the central or local government to arrange the schedule of appropriation. And it makes difficult for the sub-level government to prepare their budget accurately in advance. At the same time, the upper-level government cannot implement an efficient supervision of the spending of fiscal grants through an

information system, which may easily result in misuse.

Chapter 5 The Fiscal transfer Systems In Sweden

In this chapter, we will analyze the Swedish fiscal transfer system in detail. We try to give a general picture of the system. Through a case study, we identify five important factors that are indispensable to an effective and fair fiscal transfer system.

Most of information and data in this chapter come from Mr. Persson, Mr. Tingvall and Mr. Hansson through interview. All of them are specialists with the Swedish Financial Department. Here we want to say thanks to them again. This chapter could not be finished without their help.

5.1 Welfare State and Social Equalization

As a Northern European country located on the Scandinavian Peninsula, Sweden has a territory of 450 000 square kilometers and a population of 8.7 million inhabitants. This is a developed, highly industrialized nation noted for its social democratic welfare system, where everyone has the equal right to enjoy social welfare benefits. The Swedish government guarantees all Swedes a similar high standard of living even if they live in different areas. On the other hand, the central government aims at developing the economy in every region by making use of their different advantages.

To our astonishment, Sweden once was one of the poorest and most undeveloped nations in Europe in the past centuries. From the beginning of the 20th century until 1970, Sweden experienced the fastest growth in the economy, only second to Japan. It attained remarkable achievements in the 20th century leading to the well-known Swedish model. The Swedish model has four famous features. One is high levels of welfare provision; second, high rates of tax; third, uniform standards based on equity and fairness, and local authorities play an important role in the delivery of these services. Among these distinguished performances what is especially noteworthy is

the founding of the Swedish equal welfare state. A typical feature of the state is that rapid development of economy and social equity are both regarded as a priority by the Swedish government so that the gap between wealth and poverty is expected to be minimized as much as possible.

The Swedish welfare state is based on the idea that everyone has an equal right to obtain health care, family services, old-age pensions and other social benefits regardless the differences of income, class and area. Certainly, since everyone is entitled to these benefits, everyone must pay for them through their taxes. Meanwhile, every local government needs to have the same opportunity to develop its economy so as to be able to afford these public expenditures. The idea has been universally accepted by the Swedish people and has become their belief in some sense.

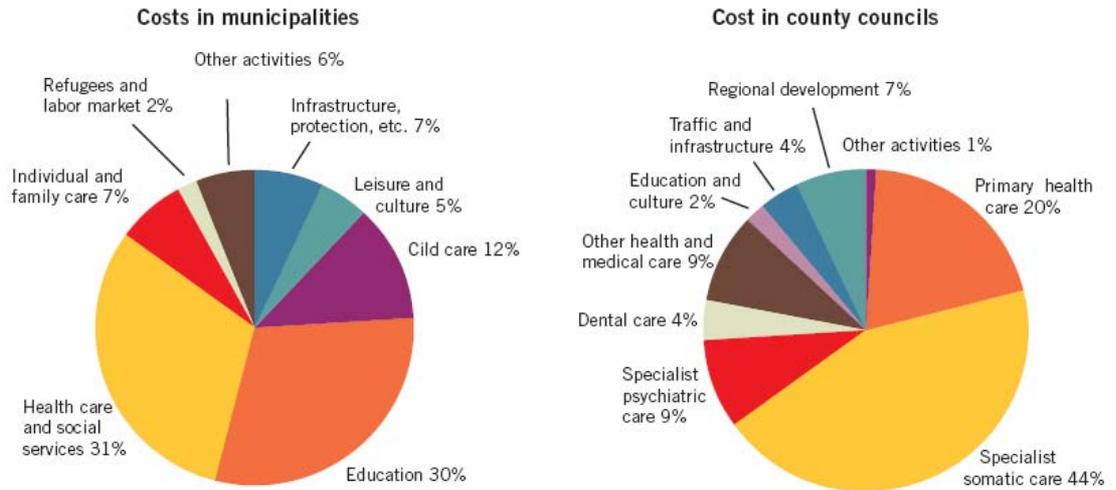
In making the idea come true, the Swedes tried to create some effective institutions to form an equal welfare state. A series of scientific inter-government fiscal transfer systems named by Equalization system were established by the central government that have played a significant role in Sweden's process of forming the equal welfare state. The Swedish welfare state has become a very valuable example for other countries in that it created a new pattern of welfare, which has been described as a model of equalization, even though in recent years Sweden encountered some serious problems with its equal welfare state such as low efficiency and overloaded taxation that need to be reformed and readjusted.

The Swedish society revolves around an effective system of local self-government. The local government dates back to 1862 and plays a vital role in the political and economic life in Sweden. There are two types of local government in Sweden nowadays, including the smallest unit, municipalities (Kommun) and the regional

unit, the county council (Landsting). The country is made up of 20 county councils and 290 municipalities. According to the Swedish constitution and the Swedish local government law, the local governments have a certain degree of political and financial autonomy and they have an extensive freedom of deciding and organizing activities, although in fact the decision of a local government is also to some extent influenced by the central government. Also, the local government assumes a major responsibility to provide public services and social welfare. The county councils are mainly in charge of medical services while the municipalities are responsible for a lot of community programs, such as education, health, care services and local infrastructure.

According to the Social Services Act, municipalities are responsible for helping people who cannot support themselves. The government must provide a reasonable standard of living for its citizens. The law guarantees the right for individuals to receive social assistance and this right can be enforced by bringing legal action in a court. Today the activities of the Swedish local government cover almost every corner of community life. Sweden has the world's largest local government sector, which runs 70 percent of public sector activities and handles most of the expenditures. For instance, in 2003, the total expenditures of the Swedish local governments amounted to SEK 608 billion, of which municipalities spent almost 70 percent of aggregate costs in the public sector and county councils spent just a little over 30 percent (Swedish Ministry of Finance, 2003). On the other hand, the local government is also a major source of jobs. Over one million people are working in municipalities and county councils. This means that almost 30 percent of the country's labor force works in local governments.

Graph 5.1 Fiscal expenditure in municipalities and county councils in 2004



(Source: Swedish Ministry of Finance)

However, local governments are now facing new challenges. One of the main problems is that they have to increase productivity and reduce costs. In Sweden, public expenditures have reached almost two thirds of the gross domestic product, GDP now. Another pressure comes from the changes in the population structure, particularly the increase in the numbers of the elderly people. Economically active people only occupy a small proportion. Therefore, the government will have difficulties raising money and assuring that those elderly people can get equal treatment. As for the local government, the most important financial burden is from education and social welfare even if constitutional laws empower the local authorities to raise sufficient taxes to deal with the problem. Greater costs result from a lot of public expenditures so that some local governments need to be guided by the central government by using the fiscal transfer system. Some local governments need to develop their economy through the system too due to less resource. In addition, the Swedish EU membership has created a new situation for the local government.

5.2 The Development of Swedish Equalization System

A big difference between population and territory exists in different local governments. Although the average population density in Sweden is about 19 inhabitants per square kilometers, the majority of the population lives in the southern part of the country. For instance, Stockholm is the largest city with about 1 850 000 inhabitants. The least populated is Bjurholm, with less than 3 000 inhabitants. Although the government hopes the flow of young and educated people would stay in sparsely populated regions, these people have not ceased to move to larger cities. Now over half the Swedish people lives in regions around the three biggest cities, Stockholm, Gothenburg and Malmö.

The main source of income for the municipalities and county councils is local income tax. For example, in 1992, this revenue amounted to Skr 270 billion. In other words, 67 per cent of total revenues were tax revenues. Local government tax revenues in 1992 take up 19 per cent of the GDP. In 2004 the average municipal tax rate was 20.80 percent and county council tax rate was 10.71 percent (Swedish Ministry of Finance, 2004). Therefore, it is easy to understand that there are a lot of imbalances in different municipalities in terms of financial resources.

In order to ensure that everyone can enjoy equal public services and social welfare across the country, the central government has set a uniform standard for public service, which is an important precondition. It means unless a uniform standard is defined by the central government, a highly centralized fiscal transfer system will be quite unlikely or even unnecessary. As local governments in poor financial positions are unable to maintain the uniform standards of social welfare central government grants are introduced to support the local governments. Grants accounted for 26 per cent of municipalities' total revenues in 1992, whereas the corresponding figure for county councils was 15 per cent. All these grants are paid by the central government

from the State budget. Different municipalities and county councils have different degrees of dependency upon revenues from grants. Some municipalities get more than 50 per cent of their revenues from State grants, while a few get only less than 10 per cent. Most municipalities, however, receive 20 per cent to 35 per cent of their revenues from the equalization system.

The target of the system is to ensure that all municipalities and county councils will be able to operate on equivalent economic terms. The state grant is a popular means that can be used in the system. State grants can usually be divided into general and special grants. Before the grant system was reformed in 1993, the majority of local governments' revenues from grants could be described as special grants. Special grants are earmarked both for compulsory and voluntary operations and are used for special purposes. They are normally related to the scale of the activities and, in some circumstances, to their quality. Special grants have often been designed with the aim of stimulating local governments to develop and maintain certain services. Some special grants have been regarded as a useful tool to support local governments as part of the central governments' overall economic and labor market policy. General grants are intended to equalize different financial conditions among different local governments that vary in tax potentials or costs. In addition, general grants are given to regions traditionally put in the poor bracket. The grants do not need to be spent on any special activities and can be budgeted by local governments freely, according to their own decisions. The general State grants are mostly made up of tax equalization grants and the new block grant for municipalities.

*Table 5.1 Major state grants to local governments**Unit: Skr billion*

Item	1990/91	1991/92	1992/93
<i>Tax equalization grants</i>	18.2	20.8	14.9
<i>New State grant to municipalities</i>			18.6
<i>Grant for the health-care system</i>	15	14.5	10.3
<i>Child care</i>	12.2	13	11.4
<i>Education</i>	32.7	31	22.3
<i>Reception of refugees</i>	2.6	3.4	3.2

(Source: the Swedish Ministry of Finance)

In 1993, a new central government grants system was introduced, and it which was implemented to set with an extensive decentralization of responsibilities and powers. In the new system most of the grants were replaced by a general government grant. The regular tax equalization grant was transferred to municipalities and county councils whose tax base per capita was below a guaranteed base. This guaranteed base was defined in advance by law. In addition, local governments could receive an extra tax equalization grant from the central government if they had any special needs. This grant would be carried out in special cases and was designed to eliminate the drawbacks of the regular grant. The most important special grants were mainly used for schools, childcare and care of the elderly. To encourage local government to shape operations in accordance with the intention of the central government, the grant system must provide some incentives too.

In one way, the equalization system is a kind of balance. Some municipalities and county councils pay the money while others get it. Although general government grants actually have accounted for the largest sums of money transferred since 1993, starting from 2003, some changes in the system have decreased general government grant levels dramatically. The system distributed 43.1 billion SEK in general government grants in 2003, compared to 66.6 billion SEK the year before.

The equalization system has brought new significant changes for municipalities and county councils since January 1, 2005. The aim is to create more equal opportunities for local authorities across Sweden like before regardless of their different structural circumstances. The new equalization system includes five segments: income equalization, cost equalization, a structural grant, a transitional grant and a per capita “regulation” grant or fee.

5.2.1 Income Equalization

Municipalities with a per capita taxable income below 115 % and county councils with a per capita tax base below 110 % of the national average have the right to receive equalization grants while those exceeding the national average have to hand in some fees to the central government. The revenue equalization has been altered from a horizontal type to a mainly vertical one; although some part of it still remains horizontal type. Since this fee only accounts for a small proportion of the revenue equalization grant, the central government has to make use of the former general grant and previously earmarked grants to supplement the main parts of it. The total amount of earmarked grants transformed into grants for revenue equalization will go up in the next three years.

5.2.2 Cost Equalization

This equalization was considered due to some uncontrollable structural factors. If the per capita cost of those factors is more than the national average, the local government can receive equalization grants from the state. If the costs are lower than the average, the municipality or county council will pay an equalization charge to the state. This is horizontal by nature, in that the equalization for spending needs or cost equalization is maintained as a horizontal equalization system, which try to equalize differences in the age distribution of the population or some additional costs. The

central government has adapted a new structural grant. This grant covers costs for the promotion of business and employment and gives much attention to low population density.

5.2.3 General Government Grants

The municipalities and county councils receive government grants calculated in relation to their respective number of inhabitants. There is also a grant – which the range is only available to municipalities – calculated according to the age structure. A transitional grant is aimed to dampen the income loss for some local authorities due to the changing of the equalization system. The transitional grant will gradually be cancelled during the years 2005–2010.

5.2.4 Transitional Regulation/Introduction Grants

These grants are planned to reduce the effect of recent political reforms and they have a marginal part in the whole policy. They were already removed this year.

5.2.5 A Per Capita “Regulation” Grant or Fee

In 2005, the Swedish parliament (Riksdag) approved that 55.2 billion SEK can be used for the new equalization system, of which 42.6 billion SEK is distributed to the municipalities and 12.6 billion SEK to the county councils. The per capita “regulation” fee is calculated as the residual between the appropriations made by the Riksdag and the net of the equalization grants and fees, the structural grant and the transitional grant to the municipalities and county councils respectively. If the residual has a positive sign it can be defined as a per capita “regulation” grant (Swedish Ministry of Finance, 2005).

Table 5.2 the new equalisation system, 2005 (Billion SEK)

	Municipalities	County council	Total
<i>Revenue equalization grant</i>	45	14.9	59.9
<i>Revenue equalization fee</i>	-3.4	-2.2	-5.6
<i>Cost equalization grant</i>	4.6	1.2	5.8
<i>Cost equalization grant</i>	-4.6	-1.2	-5.9
<i>Structural grant</i>	1.5	0.7	2.2
<i>Transitional grant</i>	1.5	0.6	2.2
<i>Sum of above</i>	44.6	14	58.6
<i>"Regulation" fee</i>	-2	-1.5	-3.5
<i>Total</i>	42.6	12.5	55.1

(Source: the Swedish Ministry of Finance)

The new equalization system has obvious merits compared with the products of previous reforms, in that fewer local governments have to pay a fee in income equalization. Regional aspects are now contained in the equalization system, while cost equalization is somewhat simplified. Different models in cost equalization are registered up and updated.

5.3 A Case in Stockholm—Some Problems of the System

Stockholm is the capital of Sweden, which is often described as the economic engine of the country with the largest population and much higher average incomes than other regions. For instance, the Swedish average GNP per capita was 255,000 kronor while that of Stockholm County was 349,000 kronor in 2001. None of the other 20 counties could exceed that average level. Since the 1960s, a number of political measures have been carried out to support less well-off regions through the use of transfers from the richer ones.

Therefore, it is natural that the municipalities and county councils in Stockholm

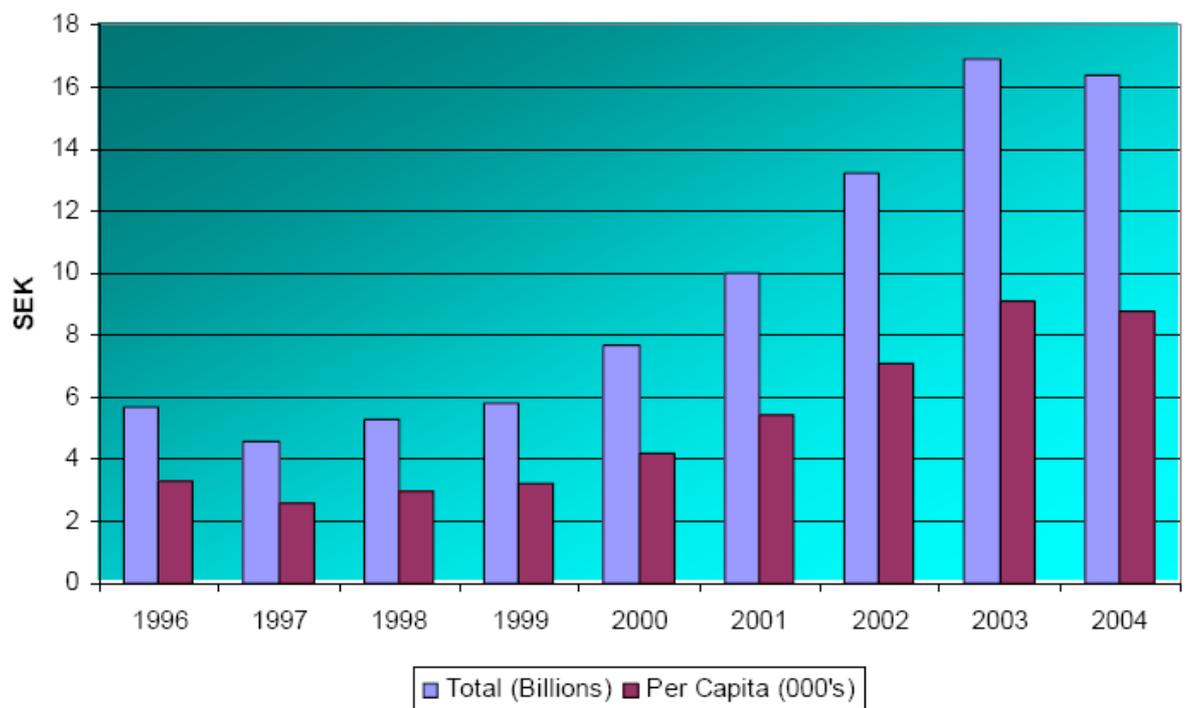
became the main contributors to the equalization system and the rest of other regions in Sweden became the receiver in certain sense, except a few municipalities in the Skåne region. The regions that receive the largest money per capita are the sparsely populated northern regions and the island of Gotland. In 2004, the Stockholm County paid 5.4 billion kronor into the equalization system, which accounted for 9 percent of the total revenues. People can find enough evidences in the following table to testify this conclusion.

Table 4.3 the Stockholm region's net contributions to the equalization system 1996-2004, SEK

	1996	1997	1998	1999	2000	2001	2002	2003	2004
<i>Billions</i>	5.7	4.6	5.3	5.8	7.7	10	13.2	16.9	16.4
<i>Per capita</i>	3268	2609	2972	3216	4223	5439	7133	9133	8813

(Source: the Swedish Ministry of Finance)

Graph 5.2 Stockholm region net equalization transfers



(Source: the Swedish Ministry of Finance)

However, some problems of the Swedish equalization system can be recognized though analyzing Stockholm's case. There are at least five problems that have caused a hot debate in the Swedish parliament.

For a start, some people think it is unfair for the citizens of Stockholm to pay too much money to the equalization system, as the general price level is higher in Stockholm than in other parts, such as costs for housing in spite of much higher salaries. Since the calculation of transfer base in the equalization system is related to the price level, people in Stockholm need to make more contributions to the equalization system than people in other regions.

The second problem is as the fastest growing region and the capital, many people always want to move into the city. But unfortunately they become a financial burden due to this transfer system. Local governments have to raise taxes to compensate for the loss. In addition, the system forces poor people in Stockholm to pay high taxes to support rich people in other regions in some ways.

The third problem is the system hampers the development of regional economy. This is problematic because the system puts regional needs before individual needs. The poor region has no incentive to improve their situation and pursue economic reforms. The notion exists with some people that one must be poor if one wants to obtain money, and consequently although the system plays an important part in the formation of an equalization society, on the other hand, it has some negative effects on the development of some regions.

The fourth problem is, some critics claim, that the system violates the principle of local self government, which means the government should have a self-finance position. According to the Swedish constitution, the local government has the right

to impose taxes to finance its own public expenses rather than getting subsidies from other regions. In addition, the local government Act says that the budgets of a local government must balance.

The last problem is the complicated nature of the system. A structural grant and a transitional grant are still necessary in the system for a lot of local governments even if the new reform were introduced before 2005. So the problem is even if some professional employees are working at the local Swedish financial department, they do not know how to calculate the exact figures of the transfer funds.

To the concern of the government, it was pointed out recently that the economy of Stockholm is declining and the region's tax base is decreasing partly due to the equalization system. Some local politicians from the conservative party and their coalition partners have put forward some suggestions to improve the system. In some municipalities in Stockholm, privatizations and a voucher system has been implemented and proved very successful in reducing financial burdens. People are looking for some more reasonable ways to deal with the dilemma between equalization and development.

5.4 Some Conclusion About the Swedish Fiscal Transfer System

Through analyzing these cases above, we notice that three different reforms played an important role in the development of the Swedish equalization system. We can draw a brief conclusion from these three reforms.

1993: All large earmarked state grants for the municipalities were put into a new block grant system, used for a far going system for equalization of differences in taxation resources. The system was intended to guarantee all municipalities an equivalent economic basis irrespective of their particular structural circumstances.

1996: Identical equalization systems were introduced for municipalities and county councils. All municipalities and county councils were included into the equalization system and the system was financed by fees from those with tax capacity over average and structural costs under average. A new and more ambitious system for equalizing all differences in structural expenditures was introduced. The general grants were calculated in relation to the number of inhabitants.

2005: The general grant has been replaced by a new income equalization grant where the municipalities guarantee an income that is 115 % of the average tax capacity and the county councils 110 %. The fee-paying municipalities in income equalization are reduced to 13 and the county councils to one. The fees for the still fee-paying municipalities and county council have been strongly reduced. At the same time no local governments become recipients of general grants calculated in relation to the number of inhabitants. Earlier included regional aspects have been lifted from cost equalization and replaced by a structural grant. A regulation grant/fee is introduced.

The fiscal transfer system is important in the process of establishing an equalization society. Then what are the most important factors to be included if the system can be described as a successful and effective one? In our point of view, at least five factors should be taken into account.

5.4.1 Responsibilities Assignment Must Be Identified Clearly

One reasonable and clear definition of respective responsibility is the priority between the central government and the local government in terms of revenue assignment and expenditure assignment.

Generally speaking, self-finance is the most important power for the local government. Otherwise the local government will have to rely on the central

government more. The precondition of self-finance is the defining of different inter-government responsibilities. In Sweden, there is a very clear division between the central government and the local government set by local government law. The local government is responsible for most public services and need provide social welfare for its citizens. Also, an indispensable role for the Swedish central government is to divide revenue assignment and expenditure assignment scientifically on the basis of the definition of local government's uniform service standards.

In Sweden, the central government is mainly responsible for national defense, diplomacy, international trade, bank policy, national legislation, and judicial affairs etc, while local government mainly provide social welfare and public services such as transportation, education, health care, environmental protection, security, fire protection, infrastructure etc. Usually, financial power belongs to the central government. In order to ensure the leading position of the central finance, the central government in Sweden takes the majority of taxes, and maintains the stability of tax revenues among governments.

5.4.2 Guideline of the System and the Target of Transfer Fund Should be Identified Clearly

The Swedish equalization system has been nicknamed after Robin Hood. It means that the rich areas have to make contributions to these poor areas so as to guarantee that every area will have the ability to provide uniform public services to their citizens. Also, every region has the same opportunity to develop the local economy. The guideline of the Swedish equalization system is very clear, and it regards fairness and equality as the priority of the financial policy. On the other hand, in order to ensure that funds can be used effectively in accordance with the intention of the central government, the target of transfer fund should be identified clearly in

advance.

As for Sweden, before 1992, the majority of transfer fund came in the form of special grants, which made great contribution to the formulation of an equalization society. The special grants guarantee the citizens can enjoy social welfare with a same standard no matter where they live. Special grants are not allowed for productivity. However, with the development of economy, general grants are getting more popular in Sweden, which can solve the financial imbalance between different local governments and have more flexibility. Another advantage in the Swedish system is that the local governments can know the exact amount of transfer funds in the next fiscal year in advance. This makes planning easier.

5.4.3 Some Specific Regulations and Scientific Formulas Are Indispensable.

Sweden's experience suggests that some specific regulations and scientific formulas are indispensable to a fiscal transfer system that can be carried out effectively. As the amount of fiscal transfer fund is large and the structure is very complicated, its operation needs to be designed regularly and in accordance with law. Sweden has drawn up laws and designed some scientific formulas which can ensure fairness and effectiveness, at the same time of increasing the transparency of the whole system.

In the process of operation, the coefficient of the fiscal transfer formula is decided by the legislative body. The target and scale of fiscal transfer have been defined by the law clearly. On the other hand, the fiscal transfer system still needs to own flexibility. The form, structure and the calculated formula of the system are not unalterable; they should keep up with the development of the economy and try to adapt to new situations. For instance, Sweden has changed its equalization system several times so as to realize its different intentions in different periods.

5.4.4 Different Diverse Means Can Be Adopted

Sweden releases both general grants and special grants in the transfer system at the same time. Generally speaking, in order to balance the financial differences of different districts, the central government often gives general grants to realize social fairness. If the central government wants to enhance the efficiency of local governments in providing public services, special grants are usually considered. Moreover, to inspire the motivation of the local government, the central government normally provides partial money while asking the local government to provide the rest of the fund. For instance, the Swedish Riksdag usually makes the budget of transfer fund after an open discussion. Then the Ministry of Finance will decide on specific means in line with the objective that has been settled by the Riksdag.

5.4.5 A Professional Administration Needs to Be Established and a Monitoring System Is Also Important.

Sweden has established an effective monitoring and operational system. The equalization system is decided by the Swedish Parliament and the regulation concerning how to calculate the different parts of the system is decided every year by the central government. Statistics Sweden calculates the equalization system and Swedish national tax board decides the grants and the fees for each municipality/county council. In October every year Statistics Sweden presents a primary calculation for the next year. Each local government has the right to complain about the result of calculation. Swedish national tax board executes the grants/fees in connection with the monthly payment to the local governments of their own taxation incomes. At one time, a powerful monitoring system has been executed to monitor the transfer system so that the transfer fund can be used in a fair and effective way. The transfer system also needs to be audited and examined by some independent departments.

Chapter 6 A New Model

In this chapter, we will develop a new model from the preceding theoretical review and case studies. We mainly follow an inductive approach in this chapter. First, we will identify the factors that should be considered when establishing an intergovernmental fiscal transfer system, and then we will compare between China's case and Sweden's case based on the analysis of those factors. In the end, a new model that aims at promoting China's intergovernmental fiscal transfer system will be formulated.

6.1 The Factors

In each case study, we have introduced the background concerning the fiscal transfer system, the main content of the system; furthermore, both the merits and problems of these two countries' fiscal transfer system were analyzed. In the theoretical review, we also studied decentralization, economic roles of local governments, and the finance of local government, along with the principles governing the design of a transfer system.

Based on the theoretical review and case studies, we think the following nine factors should be considered when establishing or improving an intergovernmental fiscal transfer system:

- Political legitimacy
- Legislation
- Responsibility assignment
- Tax autonomy
- Formulation
- Motivation

- Supervision
- Information
- Structure of grants

6.1.1 Political Legitimacy

Political legitimacy means the political purpose which an intergovernmental fiscal transfer system should adhere to. In our theoretical review, we noted that an intergovernmental fiscal transfer system is actually a kind of interest distribution between the central government and the local governments in the fiscal area. Furthermore, the case studies also indicate that political legitimacy determines the design of the fiscal distribution system. It is a precondition of establishing or promoting an intergovernmental fiscal transfer system.

6.1.2 Legislation

Legislation means that all available regulations within an intergovernmental fiscal transfer system (including such factors as political legitimacy, responsibility assignment, and tax autonomy) should be approved by way of legislative procedures. Legislation is an important guarantee that enables the intergovernmental fiscal transfer system to be more stable and transparent in the long run; in addition, it can prevent willful actions during the decision-making processes concerning the distribution of fiscal transfer.

6.1.3 Responsibility Assignment

In the context of our research, responsibility assignment means the identification of expenditure responsibilities between the central government and the local government, between an upper-government and a lower-government. Responsibility assignment is another precondition of establishing a stable and efficient intergovernmental fiscal transfer system. Without a lucid expenditure assignment,

most of the grants committed to lower level governments within the transfer system will be more difficult to be classified and measured.

6.1.4 Tax Autonomy

Tax autonomy means the local government's right to decide whether to levy a local tax or not, along with a given tax rate. Tax autonomy is always consistent with the degree of decentralization, which means the local government with a higher level of decentralization will enjoy the higher level of tax autonomy. As we know, local tax revenues and the grants from the central government compose the main source of a local government's fiscal revenue, so tax autonomy provides the possibilities for a local government to expand local fiscal revenue, which is regarded as an efficient way to help fulfilling their increasing responsibilities, with less dependence on the fiscal transfer system. So, from the angle of intergovernmental fiscal transfer system, tax autonomy is a kind of "buffer" when the system is facing the increasing expenditure pressure from local governments.

6.1.5 Formulation

Formulation refers to the degree in which the mathematic expressions are used to calculate the exact amount of each grant. In a fiscal transfer system, formulation also includes the use of the indexes that helps to indicate the differences between regions. Formulation is a technical issue to the whole intergovernmental fiscal transfer system; however, the way of designing the formulas actually reflects the extent to which the transfer system sticks to the purpose (i.e. political legitimacy), and it is crucial to achieve both transparency and equity of the system.

6.1.6 Motivation

Motivation is the inherent mechanisms of an intergovernmental fiscal transfer system, aiming at pushing the local government to implement the fiscal reforms (or policies),

which are decided by the central government. Obviously, motivation is a “generator” for the intergovernmental fiscal transfer system, which means that it would make the system work more efficiently if the motivation measures are enforced appropriately. However, it is also a knife with double-blades, because the experiences of both Sweden and China have provided us lessons.

6.1.7 Supervision

Supervision here refers to the mechanism that aims to examining and evaluating the performances of grants used by local governments. In addition, supervision plays a favorable role in finding out and overcoming the weaknesses of a certain grant, enabling the political legitimacy of the intergovernmental fiscal transfer system to be realized as expected.

6.1.8 Information

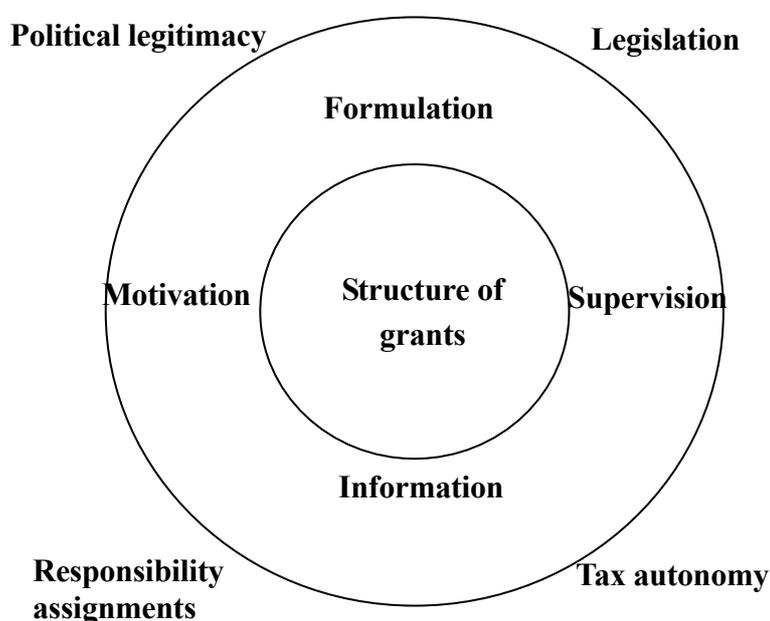
Information also refers to a mechanism that consists of the data and the channels to share the data within the whole intergovernmental fiscal transfer system. Such data are mainly the historical figures of all kinds of grants and the feedback of evaluation. In addition, the channels include the networks and the relative authorities that deal with the data. So information is the basis of an intergovernmental fiscal transfer system.

6.1.9 Structure of Grants

Structure of grants refers to the detailed structure and design of the grants (for example, the ratio of general grants and special grants). During the process of building a system, the other eight factors we have discussed above all have their own effects on the structure of grants, in this sense, structure of grants is the core of an intergovernmental fiscal transfer system, and the other factors will lose their significance without this factor.

To sum up, we can divide these nine factors into three groups: external factors, internal factors and the core factor. Among them structure of grants serves as the core factor, and political legitimacy, legislation, responsibility assignment and tax autonomy are external factors, because they have indirect impacts on structure of grants, and the other factors—formulation, motivation, supervision and information are the internal factors, since they exert their direct impacts on structure of grants.

Graph 6.1 The three groups of factors



6.2 A Further Comparison Between Sweden and China

Based on the two case studies we made in the previous chapters, we would like to make a further comparison concerning the performance of these nine factors between China and Sweden, and at the same time, the impacts (including favorable and unfavorable) of each factor on these two countries will also be mentioned. In the end, we will bring forward suggestions for improving China’s intergovernmental fiscal transfer system, along with a graph with regards to the new model.

6.2.1 Political legitimacy

Table 6.1 Comparison of political legitimacy

	Sweden's case	China's case
<i>Political Legitimacy</i>	The fiscal transfer system serves as a vital political tool, which aims at making Sweden a social welfare state with an equal society and a long-term developed economy.	The current fiscal transfer system pays more attention on the protection of local vested interests to promote the fiscal reform, with less consideration of the equalization of the fiscal revenue and expenditure among different regions in China.

- Impacts on Sweden: All designs of grant to local governments are consistent with the purpose of equalization of fiscal revenue and expenditure among regions.
- Impacts on China: The fiscal transfer system promotes the implementation of the TSS reform and the subsequent income tax reform, but it does not restrain the increasing fiscal imbalance among different regions.

6.2.2 Legislation

Table 6.2 Comparison of legislation

	Sweden's case	China's case
<i>Legislation</i>	The basic structure and elements of the fiscal transfer system are all stipulated by legislation, including the 15 indices concerning calculating the transfer amounts. Each of the expenditure concerning fiscal transfer in central budget is approved by the parliament.	There is no law in respect of intergovernmental fiscal transfer in China. The procedure of legislation has been replaced by the administrative manner in dealing with the distribution of grants.

- Impacts on Sweden: Under the authorities from legislation, all grants are distributed and used through a uniform and transparent way, which guarantees the efficient functioning of the transfer system.
- Impacts on China: With the lower degree of legislation, the management of fiscal transfer is lack of authorities, and the flexibility of fiscal transfer budget is too large, as a result, the stability of the system is lower too.

6.2.3 Responsibility Assignment

Table 6.3 Comparison of responsibility assignment

	Sweden's case	China's case
<i>Responsibility Assignment</i>	The Local Government Act identifies the assignment between central and local government very clearly, and as the supplementary of this law, there are adequate local legislations to define the detailed issues.	There is no legislation on identifying the responsibility assignment by far, and the responsibility assignment is not clear between central and local government, or between the upper-government and lower-government.

- Impacts on Sweden: The fiscal transfer is stable, because the responsibility assignment is clear.
- Impacts on China: The transfer system is unstable, due to the undefined responsibilities between various levels of government.

6.2.4 Tax Autonomy

(See next page)

Table 6.4 Comparison of tax autonomy

	Sweden's case	China's case
<i>Tax Autonomy</i>	Local governments are entitled to have some tax autonomy, which means they can determine the local tax rate by themselves.	Local governments are not entitled to have any tax autonomy, which means they cannot decide whether to levy a local tax or not, let alone the tax rate.

- Impacts on Sweden: Due to the higher level of local tax rate, the revenue motivation for the local governments has been limited so far.
- Impacts on China: The local government's motivation to increase their fiscal revenue by levying new tax or rising tax rate is limited, and it leads to heavier pressure on the grant expenditure of the central government.

6.2.5 Formulation

Table 6.5 Comparison of formulation

	Sweden's case	China's case
<i>Formulation</i>	The uniform formulas are widely used in the transfer system, including income equalization grant and cost structure grant, but the formulas seem too complicated and professional to ordinary people.	Formulas are seldom applied in the current transfer system, except the calculation of tax rebate.

- Impacts on Sweden: Both the results and the procedure of calculating grants are fair and transparent to each local government, but at the same time, the formula itself is somewhat difficult for people to understand.
- Impacts on China: The results of calculation of the grant calculations, except

those of tax rebate and other few grants, are merely the product of human estimates, or of negotiations between the central government and local governments. Consequently, the results of calculations always lack persuasion.

6.2.6 Motivation

Table 6.6 Comparison of motivation

	Sweden's case	China's case
<i>Motivation</i>	In the past, the equalization system was a kind of motivation, when most kinds of special grants were converted into general grants in 1993's reform.	Tax rebate is a main kind of motivation within the current TSS.

- Impacts on Sweden: The motivation of the local government (especially the richer regions) has been restrained; the incentive to attract residents by improving the quality of services or making the services more efficient has been significantly reduced (Deborah Roseveare, 2002).
- Impacts on China: Tax rebate stimulates the local government to develop local economy and acquire more tax revenue, but it has obviously exacerbated regional disparities.

6.2.7 Supervision

Table 6.7 Comparison of supervision

	Sweden's case	China's case
<i>Supervision</i>	The central government pays more attention to examining and evaluating the performances of public services that local governments provide, rather than the grant itself.	Supervision mainly focuses on the use of earmarked grants, but the system is not so sound either.

- Impacts on Sweden: The supervision is suitable for the current transfer system, in which general grants dominate fiscal transfer, however, such supervision is not easy for central government institutes to implement completely, and the process is not so operational.
- Impacts on China: Due to the lack of supervision, some grants are misused by local departments, and the efficiency of these parts of grants is lower.

6.2.8 Information

Table 6.8 Comparison of Information

	Sweden's case	China's case
<i>Information</i>	There are a set of perfect information systems supporting the transfer system, which integrally consist of a central financial department, local financial departments, the tax board and statistic department. Information can be shared within this system.	The information system is independent from the central government and local governments. Cooperation between the financial department and the statistic department is not regular, and most of the information cannot be shared between central and local governments.

- Impacts on Sweden: Such an information system makes the transfer system more effective and efficient, especially in the process of decision-making.
- Impacts on China: Such an information system makes the transfer system less effective and efficient.

6.2.9 Structure of Grants

(See next page)

Table 6.9 Comparison of structure of grants

	Sweden's case	China's case
<i>Structure of Grants</i>	There are five segments in the transfer system: revenue equalization grant, cost equalization grant, structural grant, transitional grant and per capita "regulation" grant or fee.	There are mainly four segments in the transfer system: tax rebate, earmarked grant, final account settlement grant and general grant.

- Impacts on Sweden: The system enables all municipalities and county councils to offer the same standard of service at the same price anywhere in the country; the present system is designed to be self-financing across the local government sector, under the "Robin Hood" principle.
- Impacts on China: The design of the grants is favorable to the promotion of the fiscal reforms, but it is helpless when facing the increasing disparities among different regions in China; the effect of "Robin Hood" is not obvious.

6.3 The New Model

So far, we have analyzed nine factors pertaining to the fiscal transfer system, paying attention to their definitions, roles and their relations with the system. We have also brought forward comparisons between the two countries, focusing on the different performances of these factors, along with their impacts on the system itself. As the consequence of our research, some suggestions have also come into being to improve China's fiscal transfer system. This chapter will conclude with a new model based on these suggestions.

6.3.1 Suggestions

6.3.1.1 Political legitimacy

Political legitimacy is a guideline to the intergovernmental fiscal transfer system. In

current China, with the development of market economy, the disparities in fiscal revenues and expenditures among different regions are increasing and as a result, a lot of social problems are emerging and may harm the stability of the society, furthermore, it will be harmful to maintain the stable growth of China's economy in the long term. So, for the sake of prompting both the stable society and economy, equalization should evolve to be the political legitimacy of China's transfer system, replacing the protection of local vested interest (the "Hold Harmless" principle). Though there will be a transition period during the evolvement, the goal is unassailable.

6.3.1.2 Responsibility Assignment

The expenditure responsibilities among all government levels should be clearer. This is one of the preconditions of establishing a regular and efficient intergovernmental fiscal transfer system in China. Under the framework of market economy, the functions of the government are mainly linked to sovereignty, macro management and public services, and the first two functions are the duties of the central government, while public service is the responsibility of the local government. No doubt, these assignments should be made on a legislative basis.

6.3.1.3 Legislation

The law regulating intergovernmental fiscal transfer should be constituted as soon as possible, so that it could offer legal guarantee to the principle, form, purpose of the fiscal transfer, as well as the formula and its variables. Furthermore, a specialized transfer budget should be recommended and approved by the legislation annually, ensuring the transfer system will work orderly within the legislation framework.

6.3.1.4 Tax Autonomy

Local governments should be entitled to have some tax autonomies, so as to have an

adequate and fixed tax base to support their administrative activities. Certain measures can be considered:

- Taxes that are crucial to regional economy but indifferent to macro economy should be decentralized to the local government, so that the latter can decide whether to levy a given tax or not, and how to adjust the tax rate.
- To pave the way for tax autonomy, the two administrative levels— Prefecture and Township in China can be removed. This means the five levels of government in China will be transformed into three levels: Central government-Provincial government-County government.

6.3.1.5 Formulation

The scope in which formulas are applied should be enlarged, and factor analysis, in the light of the Sweden experience, should gradually replace the traditional way of subjective estimate. As for factor analysis, we think these variables are worthy of consideration:

- General factors: such as population, area and the setting of administrative authorities, and so on;
- Social development factors: such as the service level of science, education, culture, sanitation, the scale of administrative authorities and their staffs;
- Economic development factors: such as the difference of prices among regions, per capita GDP, and so on;
- Special factors: such as poverty-stricken areas, autonomous ethnic minority areas, and so on;

- Natural environment factors: such as climate, resources, transportation conditions, and so on.

The central government is responsible for classifying and scoring these factors according to their impacts on local development, and then deciding on the amount of grants delivered to the local government.

6.3.1.6 Motivation

From the experiences of both Sweden and China, we should learn to balance the richer regions and the poorer regions during the process of motivation:

- With the implementation of tax autonomy at the local government level, the scale of tax rebate of VAT should be limited. The central government should no longer pay the local government the increase of VAT, which means the tax rebate will finally be a grant with a fixed amount.
- The policy of rewards should be implemented in the regions with financial problems. The rewards should be delivered by way of general grants, aiming at stimulating those regions to increase local tax revenue, or streamline their organs.

6.3.1.7 Supervision

It is necessary to enhance the supervision system within an intergovernmental fiscal transfer system. But at the same time, it should be operational in practice. China should further improve its regular report system, auditing system and punishment system, monitor the use of earmarked grants, and avoid unreasonable distributions. In addition, an evaluation system that aims to judge the performance of grants (i.e.

the standard of public services provided by the local governments) should also be set up.

6.3.1.8 Information

Both the collection and the integration of data (input and output of intergovernmental fiscal transfer system) should be enhanced for an efficient and effective system, and the following two issues should be paid attention to:

- The resource of the information. A shared data base should be established between the financial department, the tax department and the statistic department; furthermore, a system that promotes the cooperation between these departments is also needed.
- The credibility of the information. The newest information should be updated as soon as possible; in addition, the calculation caliber must be uniform between the financial department and other departments.

6.3.1.9 Structure of Grants

The central task is to adjust the form of fiscal transfer, decline share of the tax rebate till finally terminate it. At the same time, the design of grants should be consistent with the principle of “Robin Hood”, enabling the citizens in different regions to receive public services at similar levels, and fulfilling the political legitimacy of equalization in the society. Three measures should be considered in practice:

- Reduce the share of tax rebate while increase the share of general grants. China should narrow the scope of tax rebate, and alter certain proportion of it into the resource of general grants. With the gradual reduction in the amount of tax rebate in several years, general grants based on tax rebate will finally replace tax

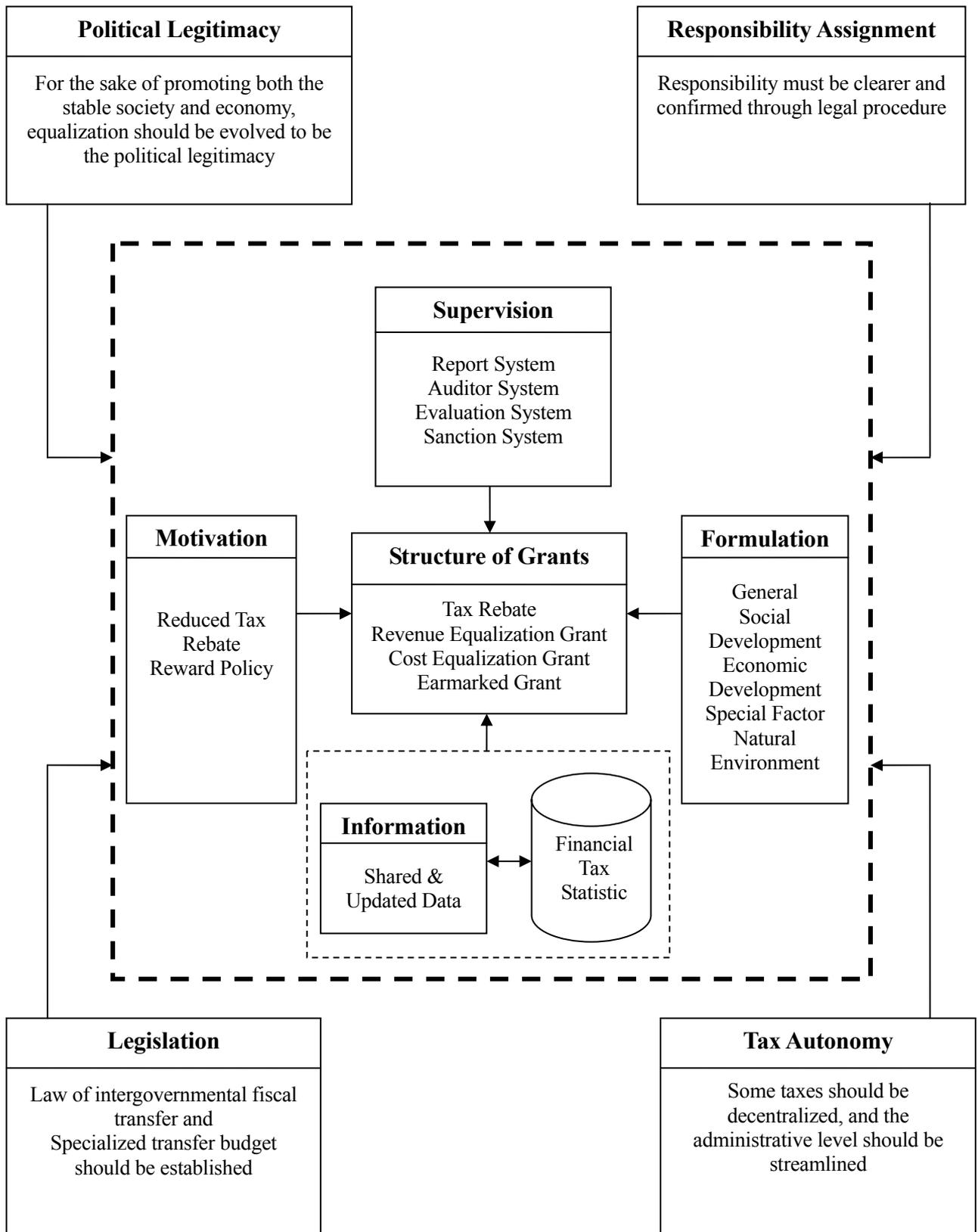
rebate.

- Set up the revenue equalization grant and cost equalization grant in separation within the framework of general grants. Local governments with a higher-than-average tax base per capita and a lower-than-average expenditure level will pay charges to those local governments with a lower-than-average tax base per capita and a higher-than-average expenditure level. In other words, these two kinds of grants should be basically self-financing across the local government sector.
- Improve the design of earmarked grants. Based on the expenditure assignments, those earmarked grants for the central government duties will continue to exist; as to the duties shared by the central government and the local governments, relative earmarked grants should be paid by these two level governments together at a calculated ratio.

6.3.2 The New Model

Basing on those suggestions mentioned above, along with the structure of these three groups of factors (see Graph 6.1), we can now develop the new model concerning the improved China's intergovernmental fiscal transfer system as following:

Graph 6.2 The new model of intergovernmental fiscal transfer system of China



Chapter 7 Conclusions

The conclusions are presented. In this part, we first summarize the dissertation. Then we suggest modifications to the created transfer system, make improvements on the chosen methodology and offer suggestions for further research. Finally, the practical implications of the research are discussed.

7.1 Summary of Dissertation

Recently, public expenditures have increased rapidly in some developed countries, due to rising demands from median voters and needs for adjusting market failures, etc. Transfer payments are determined by demographic situations, household structures, economic situations and equity considerations. Theories of local government economies argue that responsibility assignment of providing public goods between governments depends on how large an area the public goods benefit. Decentralization issues encourage local governments to earn more autonomy in deciding on their social affairs by considering variations in preferences and efficiency of service provision. In order to fulfill its responsibilities effectively, the local government should make its revenue meet the financial demands of undertaking the responsibilities.

Grants are important financial resources for many local governments. Grants can be distributed to correct for externalities, to supplement the revenue gap of local governments and to diminish horizontal and vertical inequalities. Grants given with this purpose are called equalization grants. According to the *European Charter of Local Self-Government*, inter-government grants “correct the effects of unequal distribution of potential sources of finance and of the financial burden they must support”. In Europe, some countries like the UK and Denmark, pursue full equalization by the grant system. Other countries including France and Italy, adopt a

partial equalization grants system.

A good inter-government grants program observes certain principles, grants should be: (1) determined in an objective and open way; (2) the program stays relatively stable over a certain period; (3) transparent; (4) grants assist local governments in achieving its equalization purpose and special objectives, such as education and infrastructure. Besides, the World Bank suggests that local governments should have autonomy in deciding their priorities and have adequate finance to undertake its responsibilities.

According to Jorge Martinez-Vazquez, a special independent “Grants Commission” is required to design and monitor the whole grants system. Periodical evaluation is desirable in order that grants are distributed efficiently and equitably.

In order to create our own equalization transfer model, we integrated all the related theories that have mentioned in the theoretical review chapter. In addition, we made detail research in the Chinese and Swedish inter-government transfer system. In a previous chapter we analyzed both the Swedish grants system and the Chinese grants system. In China, there are 5 fiscal levels. The current fiscal distribution system is a tax-sharing one. As a part of tax-sharing system, the fiscal transfer system consists of tax-rebate, earmarked grants, equalization grants and final account settlement grants. In the Ningbo case, we discovered some problems with this system, a major one being the horizontal fiscal disparity. The disparity is caused by tax rebate. Other problems have to do with lack of legislation and supervision, lack of clear division of responsibility assignments between different levels of governments.

The Swedish welfare state is known as the Swedish model in the world. Its basic idea is egalitarian and, therefore, the Swedish fiscal grants system is based on the

equalization principle. There are valuable aspects in the Swedish grant system. First, a reasonable and clear definition of respective responsibilities serves as the basis for the central government and the local government in realizing revenue assignment and expenditure assignment. Second, the guideline of the system and the target of transfer fund are identified clearly. Third, some specific regulations and scientific formulas are indispensable. Fourth, diverse means can be adopted in accordance with different objectives and situations. Finally, a professional administration needs to be established to execute the specific operation and a monitoring system is also important.

After a comparison of the two systems, we summed up nine important factors in our equalization transfer system. We placed the nine factors into three levels. One level is external factors, which are political legitimacy, responsibility assignment, tax autonomy and legislation; the second level is internal factors, which include formulation, motivation, supervision, information; the third level is the core factor, which is the structure of inter-government structure. They constituted the created equalization transfer system which could provide advices for Chinese transfer system reform in future.

We applied an inductive approach, which includes a review of the theories that relate to the inter-government fiscal transfer system. Through the case studies on Sweden and China, our new model can be developed and outlined. Our conclusion can be supported by qualitative data collected and gathered by a semi-structure interview, which will contribute to the validity and reliability of our dissertation.

7.2 Modifications to the Created System

We created a new grants system as modification to the present Chinese grants system. Our intention is leading the grants system into the direction of horizontal

equalization. For this purpose we design internal and external institutions.

For external institutions, political legitimacy should function as an orientation for the establishment of an equalization society, rather than merely as an instrument of protecting local interests. The local government has a greater tax autonomy to ensure their adequate revenue. In addition, Chinese legislation needs to draft a law for grants. Furthermore, the division of responsibility needs to be stable and clear.

About internal institutions, an easy and objective formula is introduced. Some variables are considered when calculating the grants to local governments. The variables include general factors, economic development factors, natural environment factors, etc. In the process of motivation, the role of tax rebate of VAT will be diminished and on the contrary, general grants will be increased. Besides, the new system calls for improvements on the regular report, audit and punishment system. In addition, data and information about transfer design and supervision should be collected with sufficient credibility. Finally, the structure of grants--the core factor should be adjusted towards larger shares of revenue equalization grants and cost equalization grants in the framework of general grants. Earmarked grants design needs to be improved as well.

7.3 Suggestions for Further Research

As the created grants system is proved feasible by theories and experiences in Sweden, we have reason to believe that China can adopt the system for equalization purposes. We also believe that further research is necessary to make the system perfect.

In order to apply the system to China's actual situation, further research should examine these issues:

Some factors are related to political decisions. We have to discuss the possibility of this kind of reform, or propose a reform not only including grants system but also political ideology and government implementation systems.

There are more data to collect when considering applicability. In China, regional gaps are huge. In order to obtain more accurate results, we should carry out investigations in more cities of China. In addition, we should collect experiences from developing countries that are similar to China, like India.

In our model, the important step is to reduce the tax rebate rate and increase general grants intended for poor areas. It may be a disincentive for rich area to collect taxes. Thus, how to keep the rich government collecting taxes while performing full equalization nation-wide will be an important research project in current Chinese situation.

7.4 Methodological Criticism

Our research was conducted through a semi-structural interview. We designed ten different questions that are important for our analysis of the Swedish case. According to our original plan, we would interview with some leaders in different political parties. We hope they would give us some different ideas from political perspectives. We tried to contact several parties in Kristianstad and Malmö. However, finally, we failed to have a dialogue with these leaders who could have given us a better understanding of the Swedish equalization system and modifying these important factors and our new model we inducted in our dissertation.

On the other hand, as far as information resource is concerned, we only chose Ningbo and Stockholm as our main research cases. It would have been good to select

more cases so that we could make our research more objective and comprehensive. Due to the time constraint, we only focused on some most important theories that are directly related to our new model. If our theoretical review had been conducted during a longer period of time it might have been possible to get more information.

7.5 Practical Implications

The new system is most important for Chinese financial leaders, even state leaders who are confronted with the increasing gap among different areas. It has provided a complete picture of how to use fiscal transfer to establish an equalization society. It is beneficial to Chinese government as an advice to modify their political ideology, and also helpful to the Chinese administrations in that it helps rearrange fiscal resources in order to achieve an equalization society.

For fiscal or grants monitoring departments, we also give details how to design and monitor the grants system. We hope the created model will be beneficial for the Chinese administration to implement the equalization policy in the near future.

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Appendix

Interview Questions: Mr. Per Persson in Kristianstad Financial Department and Mr. Mats Hansson in Malmö Financial Department

What are the roles of local government? Is the responsibility assignment between central and local government clear?

1. Can the local tax revenue meet the financial needs? If cannot, how to supplement it?
2. How to prepare the budget of local expenditure? Which factors are important in terms of arranging the local expenditure?
3. What are the influences on local tax basement and local government affairs caused by the decentralization?
4. What are the main objective of transfers and the whole picture of equalization system? Is it indispensable in the process of forming an equalization society in Sweden?
5. How about the influences of transfers on local government, society and economy?
6. What are the principles of equalization system design?
7. What is the decision-making procedure about a certain grant, whether it is according to bargaining or by a series of formulas?
8. How to supervise the use of grants?
9. What are the main advantages and problems related to the current system? How about the tendency in future?

Interview Questions: Mr. Lennart Tingvall in Financial Ministry in Stockholm

1. What are the main ideas behind the three reforms of Sweden's equalization system respectively initiated in 1993, 1996 and 2005?
2. What are the merit and the shortcoming of the new (2005's) equalization system?
3. What're the roles respectively played by the local financial department and the statistic department during the process of preparing the state's subsidy budget?

Interview Questions: Politician in Stockholm

1. What factors are important in prompting the process of equalization? Does the equalization system play a vital role during this process in Malmö (an example will be better)?
2. How to assess the current equalization system? Is it both effective and fair?
3. Can you give us any proposal for the future reform of equalization system in Sweden?